Office of the Under Secretary of Defense (Comptroller) (OUSD(C))

Preparing for Audits of Accounts Receivable and Accounts Payable Course

Student Guide

Version 1.0 **October 2005**

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An Employee-Owned Company

Course Title	**Preparing for Audits of Accounts Receivable and Accounts Payable**
Course Identification	Course Code: OSD-AR-AP Course Type: F
Level and Type	Introductory Functional Course
Course Length	8 hours 8 CPE credit hours
Field of Study	Accounting and Audit, Government Accounting and Reporting – Specialized.
Course Description	The Preparing for Audits of Accounts Receivable and Accounts Payable course, Version 1.0, is an eight-hour, introductory functional course designed to help students recognize and document Accounts Receivable and Accounts Payable transactions; verify Accounts Receivable and Accounts Payable balances and related footnotes; understand the impact of all roles and responsibilities concerning receivables and payables to the audit process; and understand the effects of intra-governmental eliminations.

Learning Objectives

Upon completion of this course, the student will be able to:

- define receivables and payables and identify audit requirements
- explain receivable recognition, reconciliation, intra-governments elimination processes, and verification of account balances (down-top, top-down)
- describe payable authorization, recognition, and reconciliation processes; intra-governmental eliminations of payable balances; and audit processes as they relate to payable balances and accompanying notes
- describe the steps to prepare for the assertion of Accounts Receivable and Accounts Payable as outlined in the Financial Improvement Initiative Business Rules.

Presentation Mode	The primary methods of instruction are conference, questions, discussion, and a final examination.
Who Should Attend	The target audience for this course includes all individuals who require an understanding of the complexities surrounding documentation of Accounts Receivable and Accounts Payable in relation to the financial statements audits. It will be composed of civilian and military personnel of various grades and ranks in positions of Financial Management, Professional and Technical Support, Accounting, Auditing, and Budgeting.
Prerequisites	There are no prerequisites for this course.

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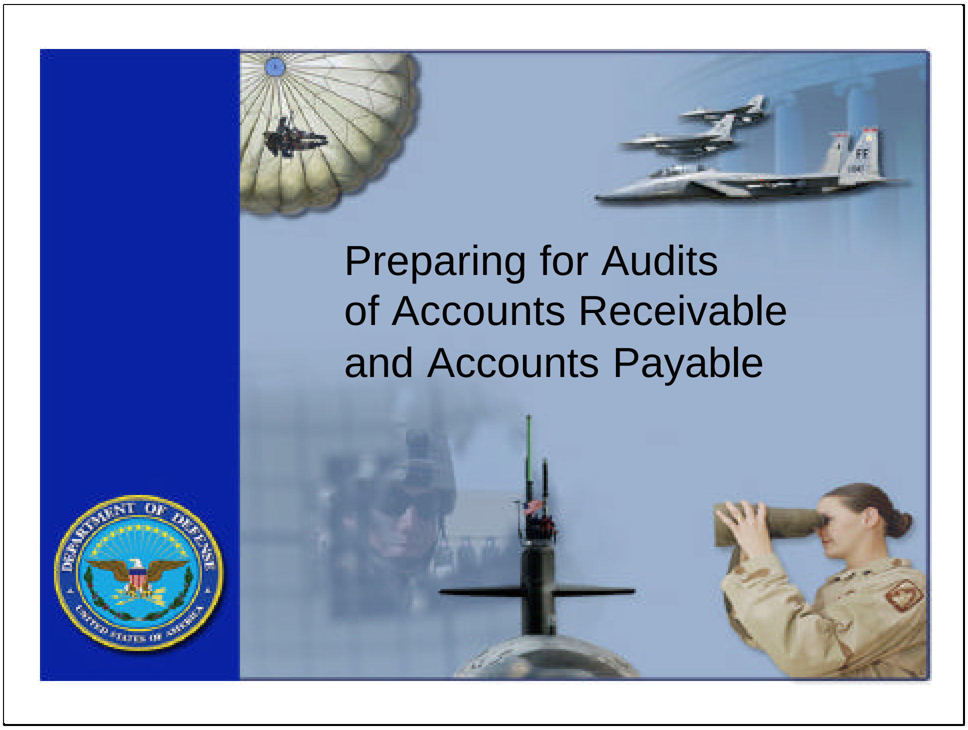

Good morning and welcome to the Preparing for Audits of Accounts Receivable and Accounts Payable course.

This course is presented in four lessons and designed to help you understand how your work in Accounts Receivable and Accounts Payable transactions affect the financial statements and audits.

Ask yourself if you know exactly what it means to be ready for an audit of your Accounts Receivable and Accounts Payable. Do you know what the auditor needs to see to verify your balances, and is this information readily accessible? Are your receivable and payable processes in accordance with Generally Accepted Accounting Principles (GAAP) and can you prove it?

The importance of this information will be explained to you. But before we get into more in-depth information, let's discuss some important points.

- **Meet your instructor**
- **Housekeeping issues**
- **Other**

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Since we are going to be together all day, I would like to start by introducing myself. I am _______________ and ….. (name, background, and what makes you uniquely qualified to instruct this course).

Now let’s talk about a few general housekeeping topics.

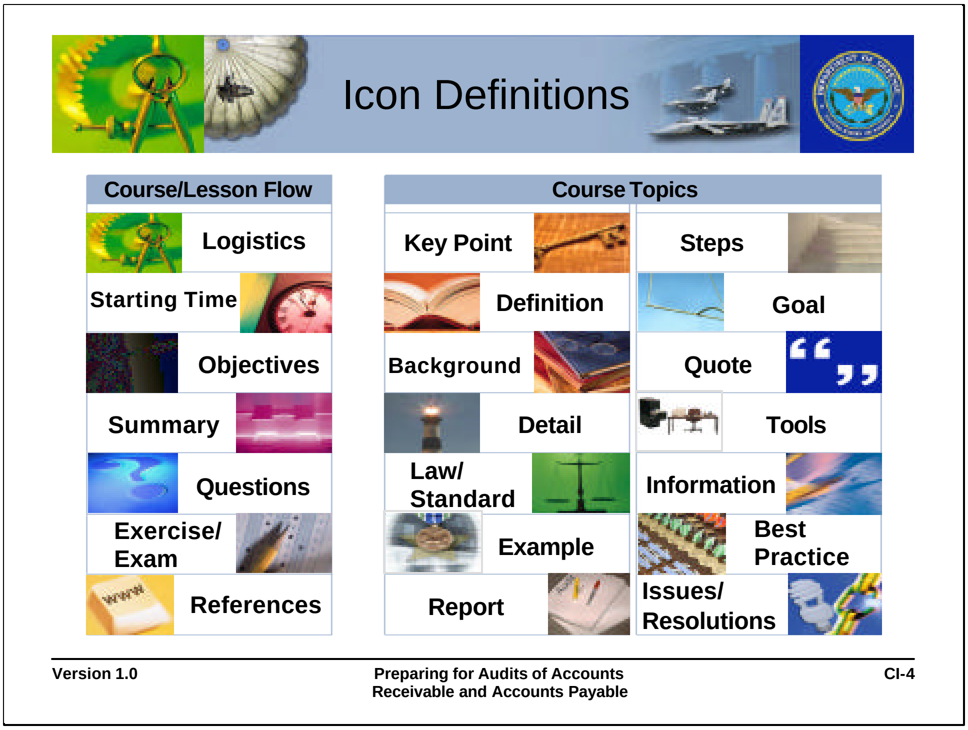
Restrooms are located at _______, and break facilities, coffee, and snacks are located at _______. Drinks and snacks are not allowed in the classroom.

Please silence all pagers and cell phones, and refrain from their use while in the classroom. If you must stay in contact, please leave the room to answer a silent page. Telephones for your use are located at _______.

During this discussion, you will be provided with examples of financial transactions and other proprietary information either from the instruction or from your classmates. You must assume that this information is not for use by the general public, nor is it to be published or disseminated to third parties.

The format for this class is conference/lecture and will include questions and discussion. There are no practice exercises, but there is a final examination. You may use any materials provided in the course or discussion to complete the examination.

Let's take a look at these materials.



Notice that each page is formatted with a header. The left corner of each header contains an icon that provides a visual key to the contents of the page. For example, this page displays the Logistics icon.

The main icons describe course and lesson objectives and introduce key topics. Additional icons within each topic represent definitions, background information, and issues and resolutions. Best Practice and Example icons will show examples of successful practices implemented by the government or industry. At the conclusion of each lesson, icons will represent the lesson summary, questions and answers, final examination, and links to references available for more information.

Please feel free to take notes on your student materials, and to write down any questions that you have that we may not have had time to address during the discussion of a particular topic. Your questions are very important to us, but we may not have the answer or sufficient time available in the classroom and may have to go to an outside source for an answer.

Now let's examine the course agenda.

Time	Title
8:00 - 8:10	Introduction
8:10 - 9:35	Lesson 1, Overview of Receivables and Payables
9:35 - 11:30	Lesson 2, Accounts Receivable
11:30 - 12:00	Lesson 3, Accounts Payable
12:00 - 1:00	Lunch
1:00 - 2:30	Lesson 3, Accounts Payable (cont.)
2:30 - 3:30	Lesson 4, The Assertion Process
3:30 - 3:40	End-of-Course Review
3:40 - 4:30	Final Examination and Final Examination Review
4:30 - 5:00	Course Critique

This is our road map for the day.

Class starts promptly at 8:00 a.m. and will break for ten minutes each hour.

Lunch is scheduled from 12:00 to 1:00 and the course ends at 5:00 p.m.

In this course, there are four lessons, an end-of-course review, and a final examination. Lessons 1 and 2 will be completed before lunch, and Lessons 3 and 4 at 3:30. Finally, you will complete a course critique and the instructor will distribute the course completion certificates.

Let's discuss the purpose and objectives for this course.

Course Overview

This course is designed to help you understand how your transactions in Accounts Receivable and Accounts Payable affect financial statements and audits.

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This course is designed to help you understand how your Accounts Receivable and Accounts Payable transactions affect the financial statements in an audit.

It is important to understand that no matter what level of the organization you are in, your role in processing transactions in Accounts Receivable and Accounts Payable has an impact upon the preparation, documentation, and reporting of information that supports management assertions in preparation for the Department’s consolidated financial statements audit.

Let’s look at the course objectives.

Course Objectives

Upon successful completion of this course, you will be able to:

- **Define receivables and payables and identify audit requirements**
- **Explain receivable recognition, reconciliation, intra-governmental elimination processes, and verification of account balances**

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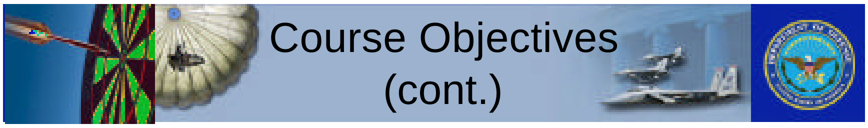
This course will provide definitions of the common terms used in receivables and payables and will describe the requirements necessary for your entity to prepare for an audit.

It will explain the specific receivables and payables processes including recognition, reconciliation, intra-governmental eliminations, and verifications.

Let's continue with more objectives.



Upon successful completion of this course, you will be able to (cont.):

- **Describe payable authorization, recognition, and reconciliation processes; intra-governmental eliminations of payable balances; and audit processes as they relate to payable balances and accompanying notes**
- **Describe the steps to prepare for the assertion of Accounts Receivable and Accounts Payable as outlined in the Financial Improvement Initiative Business Rules**

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This course will explain the importance of the relationships between the Balance Sheet, financial statements, and accompanying notes.

It will describe the necessary steps entities should take, and the required documentation for preparing to assert for an audit, in accordance with the Financial Improvement Initiative Business Rules.

Questions

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Before we proceed with Lesson 1, Overview of Receivables and Payables, are there any questions?

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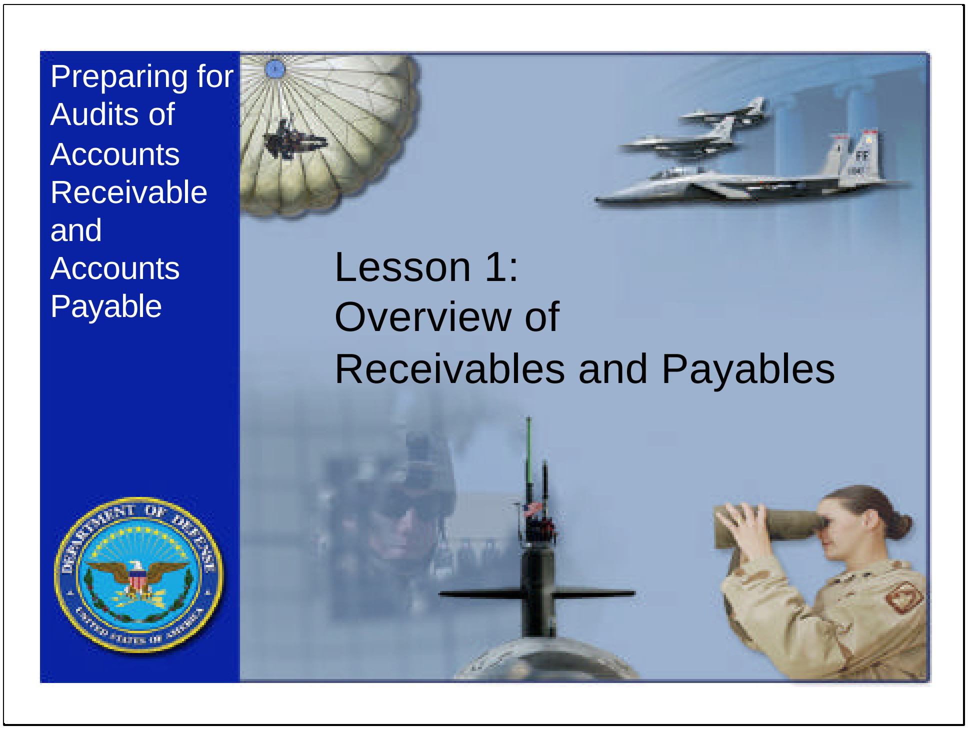
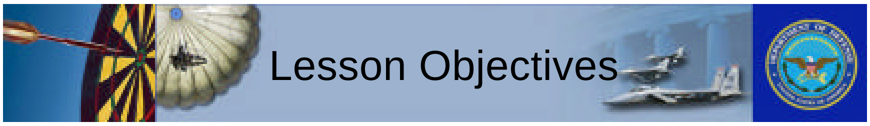


What would happen if you reported more receivables than you could collect, or less payables than you owed?

Your financial picture would look very good. Would your management be able to rely on the collection of those receivables in order to complete ongoing activities? Would they make decisions about available funds (especially at year-end) without realizing that outstanding payables were not recorded and that those funds were not available?

Audits of your receivables and payables balances attempt to determine the reliability of your reported information.

Let’s discuss the lesson objectives.



Upon successful completion of this lesson, you will be able to:

- **Recall receivables, payables, and related audit terms**
- **Explain audit requirements for receivables and payables**

In Lesson 1, we define receivables and payables and the requirements during an audit process.

Think about your role in the receivables and payables processes as we discuss typical transaction types and the rules for processing them, how and why they are audited, and what is determined in a typical audit.

Let’s look at the lesson topics.

Lesson Topics

This lesson contains the following topics:

- **Overview of Receivables and Payables**
- **Audit Terms**
- **Why Audit**
- **What Audits Determine**

In this lesson, we define receivables, payables, and intra-governmental transactions. We then discuss audit terms including management assertions, sampling, evidential matter, reasonable assurance, and types of opinions.

We describe the requirements for audits with a brief overview of the legal and regulatory requirements for audited financial statements. We discuss what audits determine in relation to the assertions made by management as presented in the financial statements and accompanying notes to include managements' responsibility for the disclosure of material deficiencies.

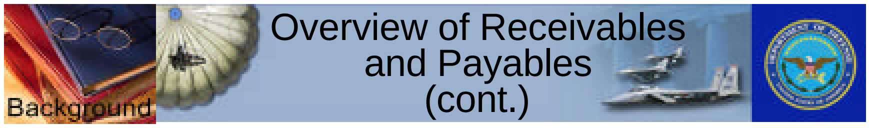
Let's begin with an overview of receivables and payables.

What are receivables, payables, and intra-governmental transactions?

- **Receivables**
- **Payables**
- **Intra-governmental Transactions**

To begin this topic, let's define receivables, payables, and intra-governmental transactions. Afterwards, let's discuss typical situations in which they are used and the rules for their recognition.

Let's look at receivables.



What are receivables?

Accounts Receivables arise from claims to cash or other assets against another entity. According to the Department of Defense (DoD) Financial Management Regulation (FMR), Volume 4, Chapter 3, receivables include, but are not limited to, monies due for indebtedness determined as a result of travel and other overdue advances, dishonored checks, sale of goods and services, fines, penalties, interest, overpayment, fees, rent, claims, damages, and any other event resulting in a determination that a debt is owed the DoD.

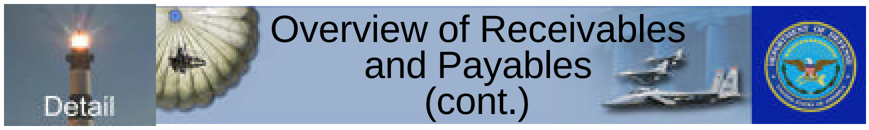
DoDFMR: http://www.dod.mil/comptroller/fmr/

Take a moment to read the definition of receivables.

Accounts Receivable arise from claims to cash or other assets against another entity. The key issue with this definition is that cash may not be the only thing we receive in settlement of our Accounts Receivable. Notice that a receivable is based on the occurrence of an event that results in an amount owed to the Department. The definition specifies several events that may result in a receivable, but does not limit receivables to the specified events.

Also notice that the web address for the Department of Defense (DoD) 7000.14-R, Financial Management Regulation (DoDFMR), is listed at the bottom of the slide. When we introduce a new reference that is used in the development of the course materials, or that we feel is helpful in your further research on the subject, we list the web address on the appropriate page as well as on the references page at the conclusion of each lesson. Receivables are defined in Volume 4, Chapter 3, Receivables, of the DoDFMR.

Let's discuss when receivables are recognized.



Accounting for Receivables

- **Timely and reliable**
- **Proper recording**
- **Internal control**
- **Proper aging**

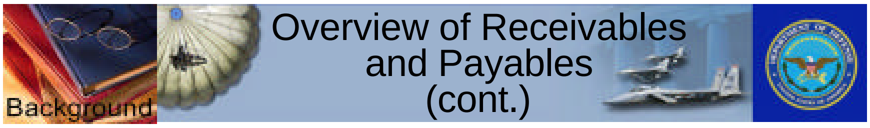
http://www.whitehouse.gov/omb/circulars/a129/a129rev.html

In the conduct of an audit, the auditor will attempt to assess whether or not you have accounted for receivables according to appropriate accounting standards. These accounting standards include the accuracy and promptness of recording receivables so as to provide timely and reliable financial status on debts owed to the entity, and proper recording of receivables using appropriate accounts and subsidiary accounts. Recording must facilitate full disclosure of the debtor, amount due, and type of debt.

The auditor will assess your internal control over receivables to ensure that all transactions affecting the receivables for each reporting period are included. The auditor will assess your provisions for credit management and debt collection as well as aging of Accounts Receivable.

A useful reference in the management of credit is the Office of Management and Budget (OMB) Circular A-129, Managing Federal Credit Programs.

In managing debt, the aging of Accounts Receivable is important. The more delinquent a receivable becomes, the greater the likelihood that it will not be collected in full. To account for the probable expense for each group of aged receivables, a reserve method is used to establish an allowance for loss on accounts and refunds receivable. This allowance is based on bad debt experience and the age of each group of receivables. Individual analysis of specific receivables may also require additions to the allowance for loss on accounts and refunds receivable. Let's look at payables.



Overview of Receivables and Payables (cont.)

What are payables?

- **Amounts owed for goods and services received by actual or constructive delivery**
- **Amounts owed for goods and other property purchased and received**
- **Services performed by employees, contractors, grantees, and lessors supported by contractor invoices and other documentation that acknowledges receipt of service**
- **Amounts owed at the end of the accounting period under programs for which no further performance of services by payees is required, such as annuities, insurance premiums, and some cash grants**

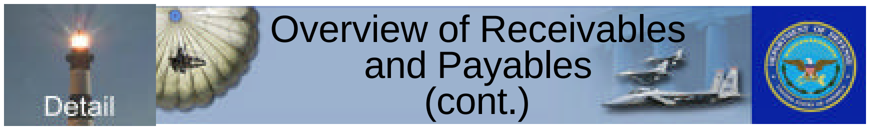
Again, let’s take a minute to review the definition of a payable.

Notice that the definition includes services performed by contractors and others. It also includes amounts owed for goods purchased and received. Even though the definition includes amounts owed at the end of the accounting period for prior services, these payments may be classified as payments for current operating costs as opposed to long-term debt.

The classification of amounts owed into the proper category becomes important when management must analyze their current operating costs against prior or projected future operating costs.

Accounts Payable are not intended to include liabilities related to on-going continuous expenses, such as employees’ salary and benefits, which are covered by other current liabilities.

Let’s examine a few rules for when payables are recognized.



Accounting for Payables

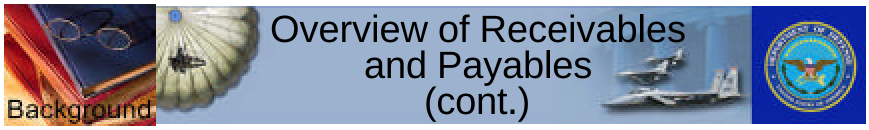
- **Recognized upon actual or constructive delivery of a good or service**
- **Supported by documentation that shows the basis for the amount recorded and payment terms**
- **Internal control is in place to ensure transactions are entered in the appropriate period, funding is authorized, and timely payment is made**

Payables are recognized upon actual or constructive delivery of a good or service. The auditor will assess whether the amounts recorded as payables are supported by documentation that clearly shows the basis for the amount recorded and the terms upon which payment is to be made. The basis for recording a payable is a receiving report that shows the quantity received and accepted or services performed and accepted by the Department. Amounts are recorded net of all discounts offered by vendors, which are economically justified. Payment terms may be specified in the contract instrument or on the invoice.

The recognition of a payable is not dependent upon the receipt of the contract instrument or the vendor invoice, but on the receipt of the goods or services. The recognition of a payable is based on when the title passes (constructive receipt), whether or not the goods are physically in the possession of the receiving activity or services have been formally accepted. This creates a dilemma to the accounting community when proper documentation to support the amount owed and proper contractual authorization is not received in a timely manner, as these documents are required to support the entry of the payable transaction into the accounting records. Proper documentation includes hard-copy receipt (or scanned copy of the actual receiving document) in the absence of a system that provides proof of the actual receiving of goods or services at the time of receipt at a loading dock, inspection point, or other point of origin. A screen print of the system is not considered a receiving report.

The auditor, in the assessment of payables balances, will attempt to determine whether or not supporting documentation is complete, internal controls are in place to ensure that all transactions are entered in the appropriate period (based on constructive receipt), authorized funding is available at the time of obligation, and payments are made on a timely basis.

Now let's explore intra-governmental transactions.



What are intra-governmental transactions?

Intra-governmental transactions are transactions among federal entities that result in claims of a federal entity against other federal entities or claims against the entity by other federal entities.

They *do not* include transactions with state and local entities, non-appropriated fund activities, or foreign governments.

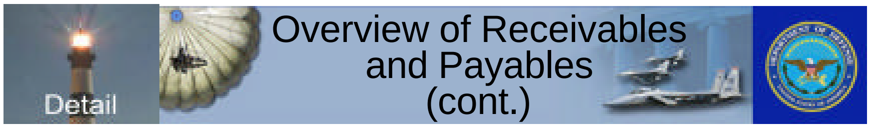
Statement of Federal Financial Accounting Standards (SFFAS) No. 1: http:/www.fasab.gov/pdffiles/sffas-1.pdf

According to the Statement of Federal Financial Accounting Standard (SFFAS) Number (No.) 1, intra-governmental assets and liabilities arise from transactions among federal entities. They do not include transactions with state and local entities, non-appropriated fund activities, or foreign governments. Intra-governmental assets are claims of a federal entity against other federal entities. Intra-governmental liabilities are claims against the entity by other federal entities. Examples of intra-governmental assets include an entity's Fund Balance with Treasury (FBWT), investments in Treasury securities, accounts and investment interest receivable from federal entities, and advances and prepayments to federal entities.

Examples of intra-governmental liabilities include Accounts Payable to federal entities and other current liabilities due to federal entities, such as receipt of federal advances and prepayments.

We are primarily concerned with intra-governmental Accounts Receivable and Accounts Payable transactions.

Let's consider the sources of some of these transactions.



Overview of Receivables and Payables (cont.)

Examples of Intra-governmental Transactions

- **Government Purchase Card (purchases from federal sources)**
- **General Services Administration (GSA) supply card purchases**
- **Transportation purchased from United States Transportation Command (USTRANSCOM)**
- **Military Interdepartmental Purchase Request (MIPR) Accepted Category I (reimbursable) supplies and services**
- **Inter/Intra-service Support Agreements**

Examples of Intra-governmental Transfers

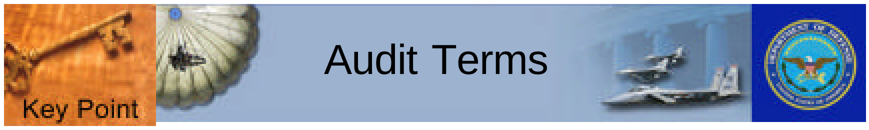
- **Assets transferred between federal partners (with or without resources)**
- **Appropriation and non-expenditure transfers**

The proper identification of intra-governmental trading partners allows for the proper accounting treatment of intra-governmental transactions to include intra-governmental transfers. This is important because when one federal entity trades with another federal entity, a sale and purchase are recorded within the federal government. Although this recording of the sale and purchase allows for the cost of operations within each entity to be correctly stated, when the records of both entities are combined (without eliminating these transactions), it results in an overstatement of the cost of operations for the government as a whole.

When we identify our federal trading partners, we allow for the elimination of intra-governmental transactions at the appropriate level of federal financial statement consolidation. Consolidated financial statements are stated at a value which reflects the results of the elimination process. Combined financial statements include the effects of intra-governmental transactions without the benefit of the elimination process.

Typical examples of intra-governmental transactions include Interfund, Government Purchase Card, and General Services Administration (GSA) supply card purchases, transportation purchases, Military Interdepartmental Purchase Request (MIPR) supplies and services, as well as services provided under Inter/Intra-service Support Agreements.

Let’s discuss some audit terms.



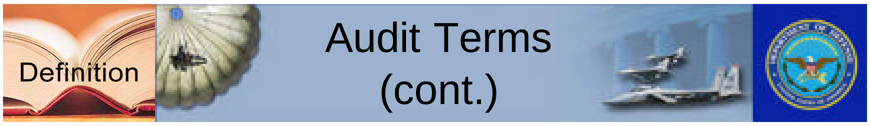
What are key audit terms that are important to the understanding of preparing for audits of receivables and payables?

- **Reasonable Assurance**
- **Materiality**
- **Audit Opinion**
- **Deficiency**
- **Systemic Weakness**
- **Management Assertions**

To understand the language used in the audit process, it is important to become familiar with some of the key words and phrases used. Some are introduced here, and a more complete list can be found in Appendix A of the Student Guide.

The definitions in Appendix A are a compilation of accounting and auditing terms used in textbooks, dictionary definitions, and common usage within the finance community.

Let's define a few of these terms within the context of an audit.



Reasonable Assurance – Assurance that a reasonable person can reach the same conclusion given the same data and circumstances (not an absolute certainty)

Materiality – Degree of importance or consequence

Sample Auditor's Standard Report

Report of Independent Public Accountants
To appropriate officials of the organization requesting the audit.

We have audited the accompanying consolidated financial statements as of (a specified date or period covered). These financial statements are the responsibility of (the entity's) management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted government auditing standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Compliance with laws, regulations, contracts, and grants applicable to (the entity) is the responsibility of (the entity's) management.

An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respect, the financial position of (the entity) as of (the specified date or period covered), and the results of their operations and their cash flows for the periods stated, in conformity with generally accepted accounting principles.

Signature of auditor and date

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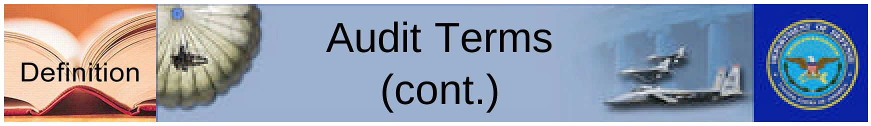
The auditors' opinion is based on reasonable assurance, as opposed to certainty. The prescribed language of the audit report ensures that the auditors define the limits of their assurance. The auditor must test on a sample basis enough evidential matter to reasonably assure that the financial statements or in the case of a limited audit, the Accounts Receivable or Accounts Payable present fairly, in all material respects, the financial position of the organization being audited.

By using the phrase "in all material respects," the auditor states the degree to which the information may be relied upon. The concept of materiality allows for minor deviations in your Accounts Receivable or Account Payable balances or procedures that may have no effect on the reliability of the statements as a whole, for example, a $100 deviation on a $1 million account balance. Using this same concept, it is possible that the auditors' opinion may be qualified by an amount or procedure that does in some way affect the reliability of the financial statements. For example, if a $100 deviation resulted in a trend that if not corrected, would have a major effect on the financial statements. This trend can become a material weakness in the entities' management controls that warrants reporting to a higher level.

Let's look at the language used by the auditor in stating an opinion.



Audit Terms (cont.)

Audit Opinions –

- **Unqualified Opinion – is without any material exception as to a general statement of reliability of the items specified within the limits of the audit**
- **Qualified Opinion – except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly the financial position of the organization**
- **Adverse Opinion – the financial statements do not present fairly the financial position of the organization**
- **Disclaimer of Opinion – the auditor does not express an opinion on the financial statements**

Deficiency – Lacking in adequate competence, readiness, knowledge, or means

Systemic Weakness – Material weakness that affects management controls across organizational and program lines and usually affects multiple DoD Components

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The most preferred finding is an unqualified opinion because it has no material exception as to a general statement of reliability. Any other opinion is deemed to be a result of one or more material departures from the Generally Accepted Accounting Principles (GAAP), such as in a qualified or adverse opinion. An adverse opinion is more severe, such as when the evidence doesn't agree with the financial statements. A disclaimer of opinion may be the result of the supporting documentation being in such disarray that the auditor can not complete the audit work and is unable to obtain sufficient evidence to support a reasonable basis for an opinion.

No opinion may be rendered on a limited scope evaluation of a process or system, such as the FBWT line on the Balance Sheet. However, audit work may be conducted in preparation for the overall evaluation of a fund, like the Air Force General Fund, for which financial statements are prepared.

When the auditors, in the course of their examination, find that an error exists in an area asserted by management, that error is classified as a deficiency. A deficiency can be immaterial and have no effect on the overall assertions of management such as a minor recording error traceable to a single document, or it can be a significant problem that involves an entire process such as an inability to verify the age or value of receivables or payables.

Systemic weaknesses are material weaknesses that affect management controls across organizational and program lines and usually affect multiple DoD Components.

Let's examine a few more terms.

Definition

Audit Terms (cont.)

Assertion –
Explicit and implicit information provided by management that attests to the represented financial position or results of operations

Excerpt from Sample Management Assertion

MEMORANDUM FOR INSPECTOR GENERAL OF THE DEPARTMENT OF DEFENSE

SUBJECT: Management Assertion for (fill in line item/financial statement)

This memorandum is to inform the Inspector General of the Department of Defense that the (ie: Army General Fund) has completed corrective actions of the material deficiencies on the (ie: Accounts Receivable) line item on the (ie: balance sheet). (ie: Accounts Receivable) is fairly presented in accordance with generally accepted accounting principles and is ready for audit. We have also completed the attached checklist indicating our preparedness.

We completed the following actions to correct the known material deficiencies in this area:

We have sufficient audit-ready evidential matter to support the transactions that constitute the (ie: Accounts Receivable) balance shown on the (ie: balance sheet). The documentation can be provided to the auditors within a reasonable amount of time. We request that the auditors provide our field sites a data request list at least three weeks prior to arriving in the field.

We understand that significant accounting resources are required to support an audit. We have sufficient knowledgeable staff available to support audit requests during audit fieldwork. We request that the auditors alert us at least three weeks prior to visiting a field site, so we can adjust schedules to accommodate the anticipated workload to support the visiting auditors.

Signed by agency financial manager/CFO

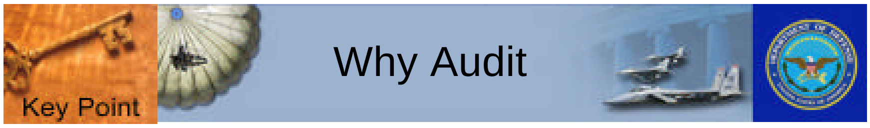
cc: OUSD(C)

Attachment
As stated

Auditors base their opinions upon management's assertions as to the existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure of reported data. For example, for existence or occurrence, management asserts that the amount reported as Accounts Receivable is based on the existence or occurrence of overpayments, refunds, fees, or reimbursable transactions.

For completeness, management asserts that all valid transactions are recorded and properly classified and that there are no undisclosed Accounts Receivable. For rights and obligations, management asserts that the proceeds of the receivables belong to the reporting entity. For valuation or allocation, management asserts that they are recorded at the appropriate amounts and valued on an appropriate valuation basis; and for presentation and disclosure, that they are properly classified in the financial statements, accounting principles are consistently applied, and footnotes contain required disclosures.

Now that you are familiar with a few of the common audit terms, let's consider some of the requirements for audits of the financial statements.



Why Audit

What are the requirements for audits of the financial statements?

- **Legal and regulatory requirements for audited financial statements**

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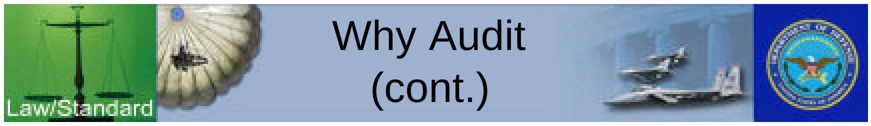
When we properly control and account for the resources used at every level of our operations, and ensure that the data used to inform our leaders on the status of their resources is reliable and timely, we provide them with the means to make informed decisions.

How many of you would invest in a company with a budget of over $400 billion yet cannot obtain a favorable audit opinion? We establish credibility and trust when we obtain a favorable opinion on a financial statement audit, and it's the responsibility of the government to its citizens to ensure that trust. Ensuring the public trust is also the foundation for many of our laws.

The bottom line is that better and more reliable information means better decisions by the Department's leadership in support of the warfighter.

Let's discuss the requirements for audits of the financial statements beginning with a look at the legal and regulatory requirements for audits of the financial statements.



Why Audit (cont.)

Federal Financial Management Improvement Act (FFMIA)

Each agency must implement financial management systems that comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the United States Government Standard General Ledger (USSGL) at the transaction level.

FFMIA: http://www.ignet.gov/pande/faec/gaoffmia.pdf

Federal Managers' Financial Integrity Act (FMFIA)

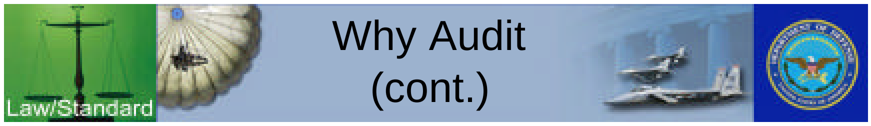
Systems of internal accounting and administrative control of each executive agency must be established in accordance with the standards prescribed by the Comptroller General.

FMFIA: http://www.whitehouse.gov/omb/financial/print/fmfia1982.html

The Federal Financial Management Improvement Act (FFMIA) is designed to increase the accountability of managers of federal resources. It requires all federal agencies to comply with federal accounting standards and reporting objectives in their financial management systems in order to support full disclosure of federal financial data, including the costs of federal programs and activities. It stipulates that each agency must implement financial management systems that comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the United States Government Standard General Ledger (USSGL) at the transaction level.

In addition to the FFMIA, the Federal Managers' Financial Integrity Act (FMFIA) stipulates that the systems of internal accounting and administrative control of each executive agency must be established in accordance with the standards prescribed by the Comptroller General. The OMB has established guidelines in the recently revised OMB Circular A-123, Management's Responsibility for Internal Control. Appendix A of this publication addresses the assessment of internal controls over financial reporting.

Let's examine more legislation.



Why Audit (cont.)

The Chief Financial Officers (CFO) Act requires that each financial statement be audited in accordance with applicable Generally Accepted Government Auditing Standards (GAGAS).

CFO Act: http://www.gao.gov/special.pubs/af12194.pdf

The Inspector General (IG) Act requires an explanation for all audit reports with recommendations open for more than one year.

IG Act: http://www.access.gpo.gov/uscode/title5a/5a_2_.html

The Chief Financial Officers (CFO) Act provides for a single source of accountability within each designated executive agency for the reporting of that agency's financial status. It requires that each financial statement be audited in accordance with applicable Generally Accepted Government Auditing Standards (GAGAS). According to the 2004 DoD Performance Accountability Report (PAR), several of the Department's subordinate agencies have received a favorable audit opinion on their financial statements. However, to date, the DoD-wide statements have received a disclaimer of opinion from the auditors.

The amended Inspector General (IG) Act requires an explanation for all audit reports with recommendations open for more than one year. Currently there are 11 material weaknesses reported in the DoD Fiscal Year (FY) 2004 PAR. These weaknesses are Department of Defense, Office of the Inspector General (DoD OIG) identified. Accounts Receivable and Accounts Payable have not been identified by DoD OIG as of yet. However, the Department is working the weaknesses its control program has identified related to receivables and payables. We will discuss these weaknesses in the next two lessons.

Now let's talk about the standards used by auditors in the conduct of audits, and regulatory guidance that the auditor uses to evaluate your policies, procedures, and practices.

Why Audit (cont.)

Generally Accepted Auditing Standards (GAAS) and Generally Accepted Government Auditing Standards (GAGAS)

- **GAAS includes the general standards, standards of field work, and reporting standards and is applicable to all audits**
- **GAGAS includes standards for audits of government organizations, programs, activities, and functions as well as government assistance received by contractors**

GAO Yellow Book: http://www.gao.gov/govaud/ybk01.htm

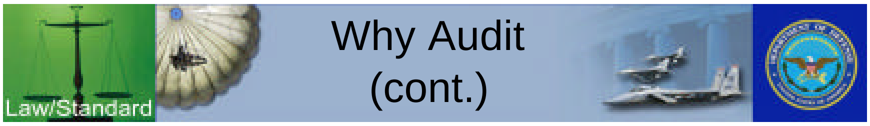
There are specific standards that are applicable to all public accountants in the conduct of audits, whether they audit a public corporation or a government entity. These standards are called Generally Accepted Auditing Standards (GAAS). These standards pertain to auditors' professional qualifications, the quality of the audit effort, and the characteristics of professional and meaningful audit reports. They include the general standards, standards of field work, and reporting standards.

GAGAS are standards for audits of government organizations, programs, activities, and functions as well as government assistance received by contractors.

For financial statement audits, GAGAS prescribes fieldwork and reporting standards beyond those required by GAAS. The Government Accountability Office (GAO) Government Auditing Standards, more commonly called the Yellow Book, incorporates both GAAS and GAGAS.

Regulatory guidance also requires the preparation and audit of your financial statements.

Let's begin with a look at the guidance available from the OMB, the Treasury, and the DoD.



Why Audit (cont.)

Office of Management and Budget (OMB) Guidance

- **OMB Bulletin 01-02, Audit Requirements for Federal Financial Statements**
- **OMB Bulletin 01-09, Form and Content of Agency Financial Statements (superseded by OMB Circular A-136)**
- **OMB Circular A-123, Management's Responsibility for Internal Control and Appendix A**
- **OMB Circular A-127, Financial Management Systems**
- **OMB Circular A-136, Financial Reporting Requirements**

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OMB guidance includes:

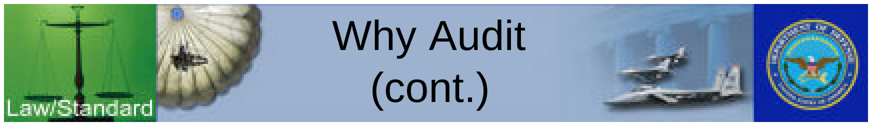
- OMB Bulletin 01-02, Audit Requirements for Federal Financial Statements
- OMB Bulletin 01-09, Form and Content of Agency Financial Statements (superseded in August 2005, by OMB Circular A-136)
- OMB Circular A-123, Management's Responsibility for Internal Control and Appendix A
- OMB Circular A-127, Financial Management Systems
- OMB Circular A-136, Financial Reporting Requirements.

OMB Bulletin 01-02 establishes minimum requirements for the audit of federal financial statements. It assigns responsibility for audits of financial statements to the IG of the executive department or agency. It discusses communication between agency management, including the CFO, and the IG, and it discusses the scope of the audit and resultant reports, management schedules and letters, agreed-upon procedures, and IG oversight.

OMB Circular A-123, Management's Responsibility for Internal Control, requires agencies and individual federal managers to take systematic and proactive measures to develop and implement appropriate, cost-effective management controls; assess the adequacy of internal control in federal programs and operations; and report annually on internal control through management assurance statements. Appendix A requires financial reporting entities to separately assess, document, and report on internal control over financial reporting.

OMB Circular A-127, Financial Management Systems, prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems.

OMB Circular A-136, Financial Reporting Requirements, consolidates, clarifies, and updates existing OMB guidance relating to agency and government-wide financial reporting. It also includes clarifications and minor reporting changes relating to FY 2005 PARs, and advance guidance for FY 2006 agency PARs. OMB intends to develop annual revisions to this circular in the future. Let's discuss the guidance available from the Treasury and the DoD.



Why Audit (cont.)

Treasury Financial Manual (TFM)

The TFM is the Treasury's official publication for financial accounting and reporting of all receipts and disbursements of the federal government.

TFM: http://www.fms.treas.gov/tfm

DoD Financial Management Regulation (DoDFMR)

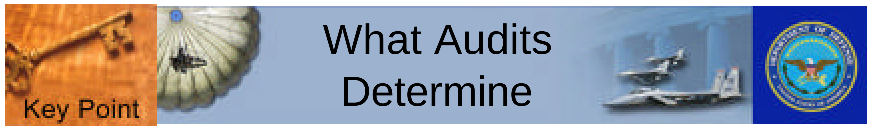
The DoDFMR provides procedural guidance to be used in day-to-day operations in order to comply with reporting rules.

The Treasury Financial Manual (TFM) is the Department of the Treasury's official publication for financial accounting and reporting of all receipts and disbursements of the federal government. It is divided into six volumes. Volume 1 of the TFM applies to all federal agencies and contains instructions in the areas of central accounting and reporting, payrolls, deductions and withholdings, disbursing, deposit regulations, and other fiscal matters. It is organized in six parts: Part 1, Introduction; Part 2, Central Accounting and Reporting; Part 3, Payrolls, Deductions, and Withholdings; Part 4, Disbursing; Part 5, Deposit Regulations; and Part 6, Other Fiscal Matters.

One main source of guidance is the DoDFMR. It provides policy, regulation, and procedural guidance to be used in day-to-day operations in order to comply with reporting rules. It consists of 15 volumes on numerous subjects within the area of responsibility of the Comptroller of DoD.

It is important to note that quarterly guidance that provides reporting updates for financial statements should also be consulted. Reports found in the Defense Department Reporting System (DDRS) are often updated quicker than the DoDFMR.

Now that we've discussed the legal and regulatory requirements that lead to the audit of the DoD financial statements and results of operations, let's discuss what audits determine.



What Audits Determine

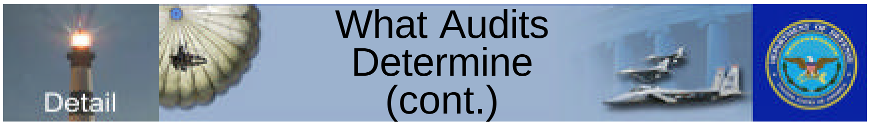
Audit Value in the Decision-Making Process

Audits provide a means of testing current data and reporting procedures to validate whether or not those procedures would enable users of the financial data to rely on the underlying information that supports the reported financial data.

DoD leadership at all levels, from the unit commander to the Commander in Chief, must be able to trust the information provided through the reporting processes. One of the most essential elements of information is financial data. Audits provide a means of testing current data and reporting procedures to validate whether or not those procedures would enable users of the financial data to rely on the underlying information that supports the reported financial data.

Auditors analyze the underlying data, policies, procedures, and controls to ensure that they provide adequate control over your resources and the associated reporting on the use of those resources. It is a top priority of the DoD to achieve an unqualified audit opinion on the Department-wide financial statements.

Let's examine the information provided through the financial reporting processes by examining the financial statements, and by focusing on the areas that are examined in an audit of receivables, payables, and intra-governmental eliminations.



What Audits Determine (cont.)

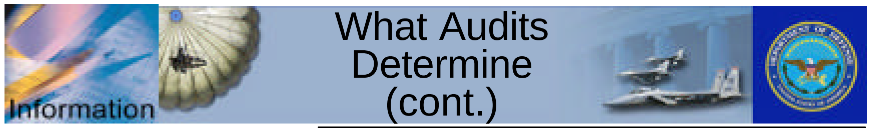
Financial Statements

- **Balance Sheet**
- **Statement of Net Cost**
- **Statement of Changes in Net Position**
- **Statement of Budgetary Resources**
- **Statement of Financing**
- **Statement of Custodial Activity**
- **Notes to the financial statements**

The financial statements are a picture of the financial position of an entity as of a point in time. Various entities within the Department prepare financial statements that are consolidated quarterly. The DoD Consolidated Financial Statements as of the end of the fiscal year, September 30, are published in the annual PAR. The financial statements are preceded by Management Discussion and Analysis (MDA) in which management provides an overview of the scope of their operations, provides a report on their internal controls and conformance to financial systems requirements, and discusses any issues that may be important to users of the financial statements. They are followed by required supplementary stewardship information and other required supplementary information. For more information, an extract of the financial statements contained in the 2004 DoD PAR is provided in Appendix B of the Student Guide.

During an audit, amounts shown on the financial statements are verified through an examination of sample data and other evidence to ensure the reliability of the reported information.

Let's look at these financial statements.



What Audits Determine (cont.)

Consolidated Balance Sheet

- **Assets**
- **Liabilities**
- **Net Position**
- **Previous year comparison**
- **Refers to Notes**

Department of Defense Agency Wide Consolidated Balance Sheet As of September 30, 2004 and 2003 ($ in Millions)	2004 Consolidated	2003 Consolidated Restated
ASSETS (Note 2)		
Intra-governmental:		
Fund Balance with Treasury (Note 3)	$ 287,685.5	$ 251,544.1
???????	????????	????????
Accounts Receivable (Note 5)	**1,118.3**	**1,066.6**
Total Intra-governmental Assets	$ 522,798.8	$ 458,609.6
Cash and Other Monetary Assets (Note 7)	2,178.1	1,534.9
Accounts Receivable (Note 5)	**7,427.8**	**7,299.9**
????????	??????	??????
TOTAL ASSETS	**$ 1,208,486.2**	**$ 1,141,309.3**
LIABILITIES (Note 11)		
Intra-governmental:		
Accounts Payable (Note 12)	**$ 1,888.4**	**$ 101.4**
??????	??????	??????
Total Intra-governmental Liabilities	13,207.1	10,538.7
Accounts Payable (Note 12)	28,309.0	27,863.8
??????	??????	??????
TOTAL LIABILITIES	$ 1,710,113.6	$ 1,559,638.5
NET POSITION		
Unexpended Appropriations (Note 18	$ 243,813.9	$ 218,869.5
Cumulative Results of Operations	**(745,441.3)**	(637,198.7)
TOTAL NET POSITION	**$ (501,627.4)**	$ (418,329.2)
TOTAL LIABILITIES AND NET POSITION	**$ 1,208,486.2**	$ 1,141,309.3

The Balance Sheet lists the Assets, Liabilities, and Net Position of the entity. The form shown is an abbreviated version of the Consolidated Balance Sheet located in your Appendix B. Notice that the use of question marks are used as placeholders for lines and amounts that are not discussed in this course.

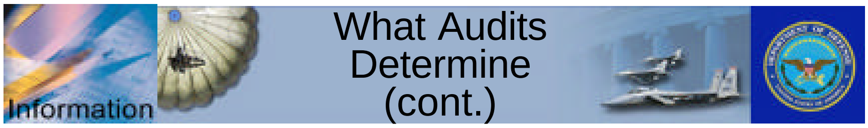
Assets represent the value of items owned by an organization. These items of ownership are the resources the organization needs to accomplish its mission. Think about them with respect to the ownership of your home or car. Your assets are used to accomplish your family's mission.

Liabilities represent the amount an organization owes to its creditors. These items are the creditors' claims against the assets of the organization. You can draw parallels to your ownership of your home or car. Do you own them outright or do you have a loan where a creditor has a claim?

The Net Position represents the worth of the owners investment in an organization. These are the owner's claim against the assets of the organization. You can once again draw parallels to your ownership of your home or car. How much did you pay as a down payment? Has the property appreciated or depreciated in value due to improvements or increases in market value?

Management uses a Balance Sheet to compare the activity of their organization as represented by the amounts shown as Assets, Liabilities, and Net Position from one point in time to a comparable point in time. They are interested in changes in amounts attributable to changes in known activity. Any changes to amounts that are not explained by changes in known activity are areas of concern for management as they may be a result of recording or reporting errors, fraud, or mismanagement. Amounts shown on the Balance Sheet are comprised of several account balances that may be consolidated within associated notes to the financial statements, or are the amounts transferred from related financial statements.

Let's examine the notes associated with Accounts Receivable and Accounts Payable.



Note 5 to the Financial Statements, Accounts Receivable

- **Provides account detail of Accounts Receivable balances**
- **Is reported net of the Allowance for Estimated Uncollectibles**

Note 5. Accounts Receivable

As of September 30	2004			2003
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net	Accounts Receivable, Net
(Amounts in millions)				
1. Intra-governmental Receivables:	$ 1,118.3	N/A	$ 1,118.3	$ 1,066.6
2. Non-Federal Receivables (From the Public):	$ 8,028.3	$ (600.5)	$ 7,427.8	$ 7,299.9
3. Total Accounts Receivable:	$ 9,146.6	$ (600.5)	$ 8,546.1	$ 8,366.5

Note 5 to the financial statements provides Accounts Receivable account detail as reported on the Balance Sheet Assets Section. It is broken down into Intra-governmental Receivables and Non-Federal Receivables (from the public).

Reported amounts are entered on the Balance Sheet net of the Allowance For Estimated Uncollectibles. Calculation of this allowance is based on prior experience with uncollectibles and other factors. The auditor will examine your method of estimating this amount to ensure that it is adequate.

Comparative amounts from the prior year are entered and any unusual differences should be explained.

Let’s look at Note 12, Accounts Payable.

What Audits Determine (cont.)

Note 12 to the Financial Statements, Accounts Payable

- **Provides account detail of Accounts Payable balances**
- **Includes interest, penalties, and administrative fees**
- **Describes guidance that pertains to reported amounts**
- **Explains fluctuations**

Note 12.	Accounts Payable							
As of September 30	2004						2003	
	Accounts Payable		Interest, Penalties, and Administrative Fees		Total		Total	
(Amounts in millions)								
1. Intragovernmental Payables:	$	1,888.4		N/A	$	1,888.4	$	101.4
2. Non-Federal Payables (to the Public):	$	28,307.2	$	1.8	$	28,309.0	$	27,863.8
3. Total	$	30,195.6	$	1.8	$	30,197.4	$	27,965.2

Intragovernmental accounts payable consist of amounts owed to other federal agencies for goods or services ordere and received but not paid. Interest, penalties, and administrative fees are not applicable to intragovernmental payables. Nonfederal payables (to the public) are payments to nonfederal entities.

Fluctuations

Intragovernmental Accounts Payable

Intragovernmental accounts payable increased $1.8 billion, (1,762 percent).

Improved business processes and implementation of estimating methodologies allowed DoD agencies to record accounts payable with agencies outside DoD. These new processes resulted in an increase of intragovernmental accounts payable for the following entities:

Army General Fund	$738.7 million
Navy General Fund	$396.6 million
Navy Working Capital Fund	$43.7 million
Air Force General Fund	$542.4 million

Note 12 provides account detail of Accounts Payable balances and includes interest penalties and administrative fees. It is broken down into Intra-governmental Payables and Non-Federal Payables (to the public).

Notice that there is a considerable difference between the reported Intra-governmental Payables from FY 2003 to FY 2004. Due to this large percentage change, the fluctuation between years must be explained.

Let’s examine the Cumulative Results of Operations, as shown on the Consolidated Statement of Changes in Net Position.

What Audits Determine (cont.)

Statement of Changes in Net Position:

- **Cumulative results of operations, adjustments, financing sources**

Statement of Net Cost:

- **Program costs, net cost of operations**

Statement of Budgetary Resources:

- **Budget and spending authority and restrictions on funds**

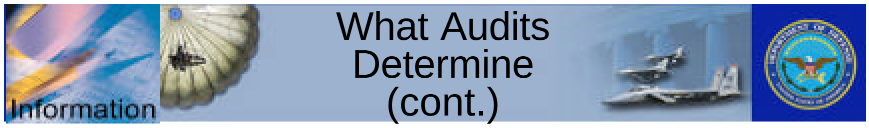
The purpose of the Statement of Changes in Net Position is to show the sources and application of funds during the year and the resulting change in Net Position. Changes in Net Position, or ownership, are the result of the receipt of spending authority as represented by appropriations received or transferred, and through other sources of financing, and are the result of the cost of operations.

The Consolidated Statement of Net Cost is designed to show the components of the net cost for the entity's operations for the period. Costs are separated by whether they are within the government or with the public. It is important that the source of costs are identified to ensure that only one reporting entity reports each identified cost.

The Net Cost of Operations is the total cost incurred by the organization less any earned revenue from its activities. The total cost of a program consists of the direct cost of the outputs produced by that program plus any indirect and administrative costs that can be assigned to the program.

The Statement of Budgetary Resources illustrates the differences between Budget Authority and Spending Authority. Budget Authority consists of appropriations received, borrowing authority, contract authority, and transfers. Spending authority is from offsetting collections. Earned authority, as a segment of spending authority, is either collected or a receivable from federal sources. It may also be in the form of a change in unfilled customer orders either with or without advances. The Statement of Budgetary Resources also shows amounts that are not available either temporarily pursuant to public law or permanently.

Let's discuss the final two financial statements.



What Audits Determine (cont.)

Statement of Financing:

- **Resources used to finance activities**

Statement of Custodial Activity:

- **Source and disposition of collections on behalf of others**

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The Statement of Financing is used to explain the resources used to finance the activities of the Department. It separates resources by those used to finance activities, and those used to finance items that are not part of the net cost of operations. The result is a total of the resources used to finance the net cost of operations.

The Statement of Custodial Activity reports on the sources and disposition of collections on behalf of others. The Total Custodial Collections should equal the Total Disposition of Collections with a resultant balance in the Net Custodial Collection Activity of $0.

Let's look at what is determined by the auditor, in the conduct of an audit on the financial statements.

What Audits Determine (cont.)

Auditor Responsibilities

- **Become familiar with policies, procedures, laws, and regulations applicable to the audited balances**
- **Evaluate internal control**
- **Examine evidence**
- **Form an opinion and report findings**

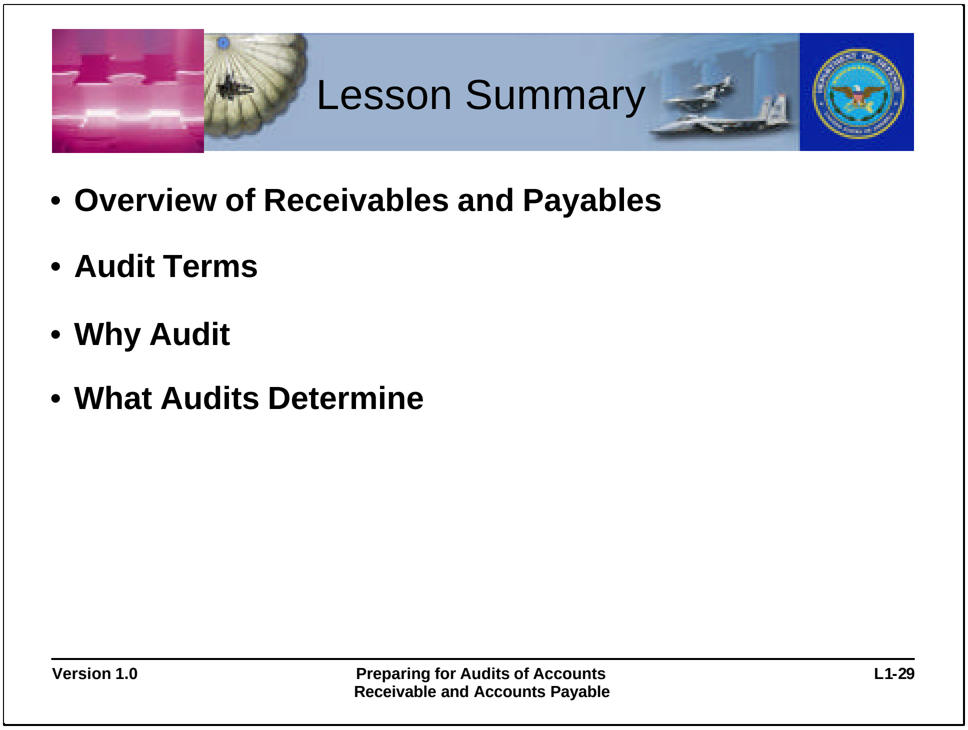
Management's preparation of the financial statements and associated notes, as well as the MDA and other information provided, is an assertion that the amounts reported exist or that the supporting transactions have occurred. By reporting financial information, management also asserts that the information is complete, that the entity has the right to the assets and is obligated for the liabilities, and that the amounts are entered at the appropriate value or have been allocated appropriately. Financial information must be presented in an appropriate manner to include all required disclosures.

The auditor must attempt to determine whether or not the assertions represented by the financial statements are based on factual data, that they are appropriately calculated, that appropriate accounting methods were used in the compilation of the data, and that there is adequate evidential matter to support the reported information.

The auditor will also examine your policies, procedures, applicable laws, and other guidance to determine whether you are following appropriate procedures. The auditor will examine your internal controls to determine their adequacy, and use that information to determine the level of testing of the evidential matter that will be required to support an audit opinion.

The audit report will describe the areas audited to include a statement as to the auditors responsibility, state an opinion or disclaim making an opinion, summarize any material deficiencies noted during the audit, and describe management's responsibility for the information that was provided as the basis for the auditor's opinion.

Let's summarize what you've learned in this lesson.



In this lesson, you learned that Accounts Receivable arise from claims to cash or other assets against another entity and that Accounts Payable are amounts owed to another entity for goods or services received. Both are recognized upon actual or constructive delivery of the good or service or upon the occurrence of an event such as an overpayment.

Intra-governmental assets and liabilities arise from transactions among federal entities, and those transactions must be eliminated at appropriate levels of reporting.

To understand the language used in the audit process, you became familiar with several terms such as reasonable assurance, materiality, various audit opinions, deficiencies, systemic weaknesses, and management assertions.

The legal requirements for audits include the FFMIA, the FMFIA, the CFO Act, and the IG Act. Auditing standards include GAAS, GAGAS, and the regulatory requirements for the reporting of financial information are contained in the OMB guidance, the TFM, and the DoDFMR.

Audits provide a means of testing current data and reporting control procedures to validate whether or not those procedures would enable users of the financial data to rely on the underlying information that supports the reported financial data.

The following slides list references available for additional information.

DoDFMR: http://www.dod.mil/comptroller/fmr/

SFFAS No. 1: http:/www.fasab.gov/pdffiles/sffas-1.pdf

FFMIA:
http://www.dod.mil/comptroller/icenter/inforef/ffmia96.pdf

FMFIA:
http://www.whitehouse.gov/omb/financial/print/fmfia1982.html

CFO Act: http://www.gao.gov/special.pubs/af12194.pdf

TFM: http://www.fms.treas.gov/tfm

References (cont.)

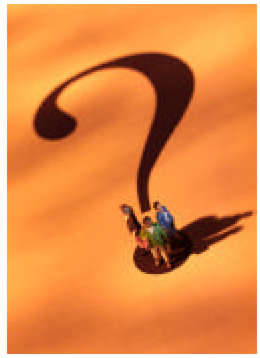
IG Act: http://www.access.gpo.gov/uscode/title5a/5a_2_.html

GAO Yellow Book: http://www.gao.gov/govaud/ybk01.htm

OMB: http://www.whitehouse.gov/omb

2004 DoD PAR: http://www.defenselink.mil/comptroller/par/

Questions



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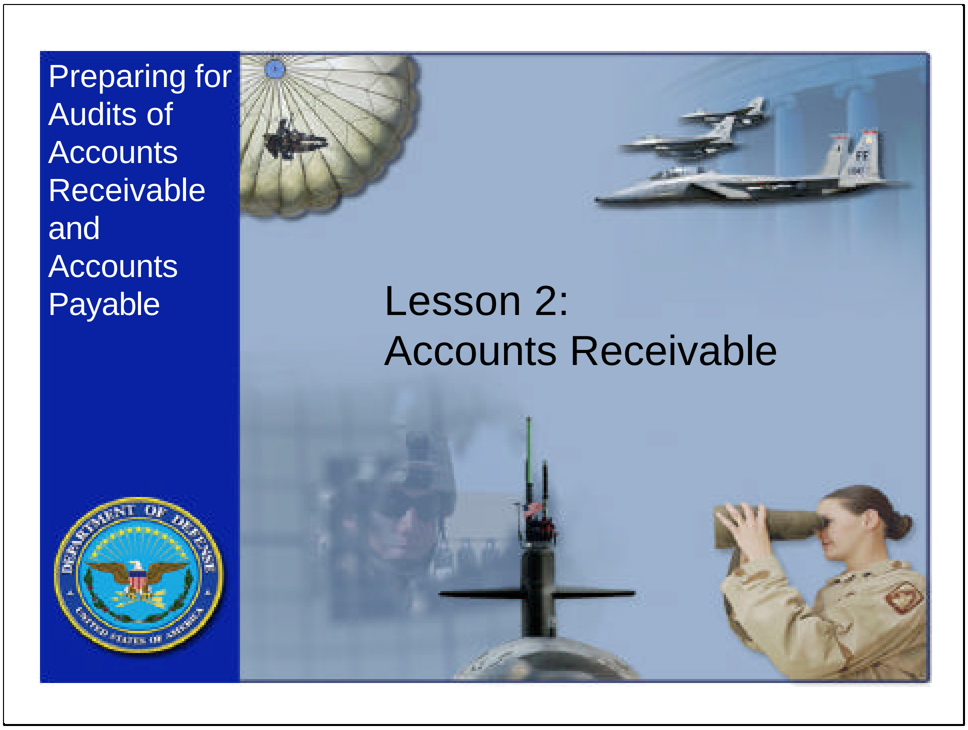
Before we proceed with Lesson 2, Accounts Receivable, do you have any questions on the material covered in this lesson?

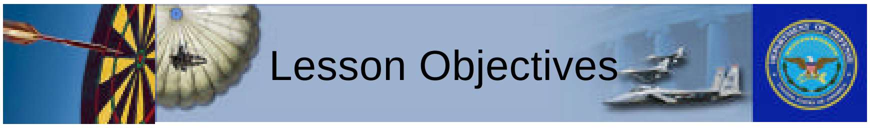


In Lesson 2, we explore the sources of receivables transactions and discuss processes associated with their reporting, reconciliation, and verification.

Reimbursable sales transactions are the principal source of operating revenue for many working capital funds, and are a major component in determining net income. They also give rise to Accounts Receivable and cash in the form of funds transfers.

It is important for you to know appropriate receivables procedures.

Let's discuss the lesson objectives.



Upon successful completion of this lesson, you will be able to:

- **Recognize a receivable transaction**
- **Reconcile receivable balances**
- **Describe intra-governmental elimination processes for receivable balances**
- **Describe verification of receivable account balances**

This lesson will cover the recognition of Accounts Receivable and the reconciliation of receivable balances. At the conclusion of this lesson, you will be able to recognize a receivable transaction and reconcile receivable balances.

You will also be able to describe intra-governmental elimination processes for receivable balances and describe the verification of receivable account balances.

Let's look at the lesson topics.

Lesson Topics

This lesson contains the following topics:

- **Receivables Recognition**
- **Debt Collection Process**
- **Receivables Reconciliation**
- **Intra-governmental Receivables**
- **Receivables Verification**

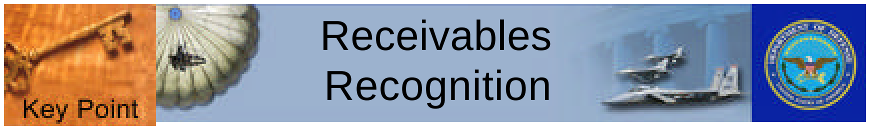
In recognizing receivables, we describe the sources of receivable transactions and discuss document handling procedures. When amounts are owed to your entity, it often becomes necessary to establish debt collection procedures. We will discuss the Debt Collection Improvement Act (DCIA) and flow-chart the debt collection process.

Due to the sheer volume of transactions, it is necessary to reconcile your receivables account balances. We will discuss the benefits of this reconciliation process and the reports associated with reconciliation.

We will discuss the need for identification of the customer in the facilitation of the elimination process for intra-governmental receivables.

We will describe the receivables verification process and some of the tools available. You will gain an understanding of the auditors' processes, as they relate to verification of your receivables and be able to utilize the same processes.

Let's begin with the recognition of receivables.



What are the sources of receivable transactions and how are receivables documents handled?

- **Sources of transactions**
- **Document handling procedures**

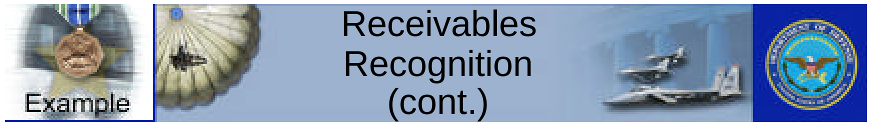
Statement of Federal Financial Accounting Standards (SFFAS) No. 1: http://www.fasab.gov/pdffiles/sffas-1.pdf

According to the Statement of Federal Financial Accounting Standards (SFFAS) No. 1, paragraph 41, Recognition of Receivables, a receivable should be recognized when a federal entity establishes a claim to cash or other assets against other entities, either based on legal provisions, such as a payment due date, or goods or services provided. If the exact amount is unknown, a reasonable estimate should be made.

While recognition is defined as the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, or expense, the recognition date is based on actual or constructive delivery of the good or service.

In this topic we will discuss the sources of receivables transactions, including reimbursable sales and related cash receipts, and the document handling procedures used to formally record the receivables transactions into the financial statements.

Can you identify the sources of some of the receivables transactions? Let's discuss a few of those sources.



Receivables Recognition (cont.)

Sources of Receivables Transactions

- **Reimbursable orders, sales invoices, or sales journals**
- **Shipping documents**
- **Fees, rental agreements, contracts**
- **Demands for payment due to fines, damages, overpayment or advances due, interest, penalties, and administrative charges**

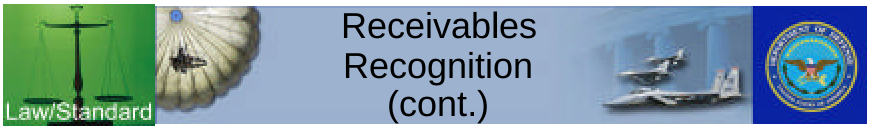
A reimbursable order may be in the form of a purchase order but may also be an electronic or customer-generated form. It should specify the item ordered, quantity, and applicable price, which may be obtained from an authorized price list. This price list may be a computer-generated master file. Sales invoices should state the particulars of the sale, including the reimbursable amount, terms, and date of sale. A sales journal is a list of completed sales transactions, but it is not adequate proof, unless all required sales information is included in the journal entry, such as customer name, item ordered, quantity, price, terms, and date of sale.

Shipping documents provide proof of fulfillment of customer orders and may include evidence of delivery, shipping terms, shipping cost (that may be billable to the customer), or any damages, loss, or shortages. Reimbursable orders must be filled before the Accounts Receivable is recognized.

Fees may be charged for services based on piece rates, hours, or usage. Examples are documents processed, hours worked in a maintenance facility, or equipment usage. Rental agreements for the use of DoD facilities by tenant organizations, contractors, or installation trailer park rentals, are just a few examples. These agreements may form the basis for the existence of a transaction, but should be supported by verification of continued usage or occupation. Contracts should be supported by evidence of the occurrence of the sale, rental, or other type of transaction.

Demands for payment may arise from overpayment of advances, overpayment on a contract, dishonored checks, fines, damage claims, shortages on shipments to the DoD, overdue payments in which interest, penalties, or administrative charges have been added, and other such events. In any event, these demands for payment should be supported by the applicable record of amounts owed.

Let's discuss the recognition of these transactions.



Receivables Recognition (cont.)

Recognition Date

The recognition date is the date of legal transfer of the asset title based on the terms of the contract or order. The prompt recording of receivables is necessary to ensure that the financial status of each entity is current.

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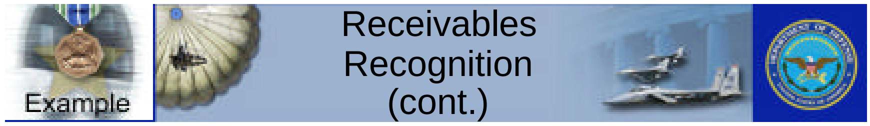
Recognition of receivables transactions begin with the receipt of a document or documents that provide evidence of the completion of an act that entitles the Department to collect amounts owed to it. The recognition date is the date of legal transfer of the asset title based on the terms of the contract or order.

The date of recognition is important due to several considerations. For example, based on the terms of a contract, the transfer of assets in a sale become the property of a buyer at the time of delivery to the Department's shipping point. In this case, the buyer owns the goods during shipment to their location. Based on these contract terms, the transaction date is the delivery date to the shipping point. Aging of the receivable may also begin on that date if in agreement with the contract terms.

For management, the prompt recording of receivables becomes critical when decisions must be made concerning operating capital, inventory management, and the cost of operations. Let's assume that a cost to produce an item (a large and very costly item) has been recorded, the item has been sold, and the recording of the sale is delayed.

This results in an overstatement of goods available for sale, an understatement of sales, and an understatement of receivables. Another result is that the labor and materials used have been charged and must be paid. If customer billing is delayed due to the delay in recording the sale, a delay in payment to the government results in a decrease in the amount of operating capital available for use on the next project.

Let's examine some common cash receipt documents and records.



Sources of Cash Receipt Transactions

- **Department of Defense (DD) Form 1131, Cash Collection Voucher**
- **Standard Form (SF) 1049, Public Voucher For Refunds**
- **DD Form 2665, Daily Agent Accountability Summary**
- **Checks and Electronic Funds Transfers (EFTs)**

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Once a transaction is recorded in the accounting records, the Accounts Receivable balance is increased. Receipts of cash, checks, and Electronic Funds Transfers (EFTs) are the most common forms of decreasing these balances. Records of cash receipt transactions are matched against the associated receivable transaction to reduce the receivable. The record of cash receipt completes the receivable cycle and is maintained as a part of the audit trail.

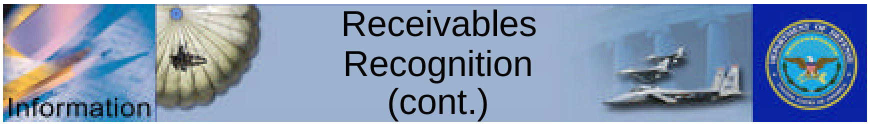
The Department of Defense (DD) Form 1131, Cash Collection Voucher, is used to document cash collections and serves as a cover voucher to support receipts collection for the three different types of collection vouchers, receipt, reimbursement, and refund. Receipts are collections credited to the Treasury Department Miscellaneous Receipt Accounts or other accounts or funds authorized by legislation. Reimbursements are amounts earned and collected for property sold or services furnished to the public or to another U.S. government agency. A refund is a recoupment (collection) of a payment made in error.

The Standard Form (SF) 1049, Public Voucher For Refunds, is used to document the refund of an overpayment received by the government.

The DD Form 2665, Daily Agent Accountability Summary, is the prescribed daily accountability document that is prepared and submitted by all deputies, agents, and cashiers to the Disbursing Officer (DO) each day. It supports the audit trail by summarizing transactions and providing a complete picture of the individual's accountability from day to day.

The most common form of receipt of amounts due is through checks and EFTs that are deposited directly into designated accounts in accordance with instructions provided.

Let's look at how receivables documents are handled.



Receivables Recognition (cont.)

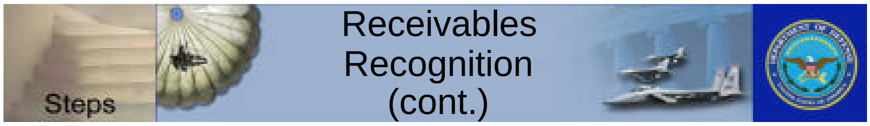
Document Handling Procedures

- **File maintenance**
- **Internal control techniques**
- **Standard Operating Procedures (SOPs)**

For document handling procedures, we focus on the references used to determine how long, at what location, and in what format files must be maintained.

We will describe internal control techniques for the processing of receivable transactions and the requirements for those techniques to be a part of your Standard Operating Procedures (SOPs). We will also review the need for reviewing and updating your SOPs.

Let’s discuss file maintenance.



Receivables Recognition (cont.)

File Maintenance

- **Retention period**
- **Location**
- **Auditor access**

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File retention, location, and auditor access are key issues in preparing your operation for an audit. Let’s take a moment to think about the reason that emphasis is placed on your file maintenance procedures.

Think about how the auditor must be able to substantiate the amounts reported on your financial statements. The auditor must be able to see the records of the transactions that make up your receivables balances. Let’s assume you have a construction contract that you have been receiving payment for over a period of nine years. The original contract files may be ten years old even though payment may not have begun until the first progress period. If the auditor selects some portion of that receivable to sample, you must be able to access all of the related documents.

Now think about how long you must maintain those documents. Are they in a location that is accessible for audit or must they be sent for? Do you know where they are? If the auditor requested them could you get them within a reasonable period of time?

Let’s look at the rules for file maintenance with these questions in mind.

Receivables Recognition (cont.)

File Retention

The DoDFMR requires that financial transactions be maintained for at least the minimum period specified in the applicable National Archives and Records Administration (NARA) General Records Schedule (GRS) and longer, if compelling reasons exist or supplemental guidance directs.

NARA GRS: http://www.archives.gov/records-mgmt/ardor

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Volume 1, Chapter 9 of the DoDFMR, provides guidance on the retention policy for financial records created or received and maintained by all elements of the DoD. It states that within the federal government, the National Archives and Records Administration (NARA) is responsible for promulgating procedures for the disposal of all U.S. government records. It states that specific records disposal guidance is contained in the General Records Schedules (GRS) issued by NARA. The DoDFMR requires that financial transactions be maintained for at least the minimum period specified in the applicable NARA GRS and longer, if compelling reasons exist or supplemental guidance directs.

DoD implemented the guidance contained within NARA in DoD Directive (DoDD) 5015.2, DoD Records Management Program, which directed DoD Components to establish and maintain the DoD Records Management Program, in accordance with the specified references. Accordingly, the Defense Finance and Accounting Service (DFAS) Manual 5015.2-I, Records Management Procedures, March 2004, provides policy, procedures, responsibilities, and definitions of terms used within file management. The companion Manual, DFAS 5015.2-M, Records Disposition Schedule, October 2004, provides an Index of Schedules (series of file types) and specific rules for the maintenance and disposition of files within the series.

Let's look at an example.

Receivables Recognition (cont.)

File Retention (cont.)

Schedule 7320, Disbursing and Collection Records

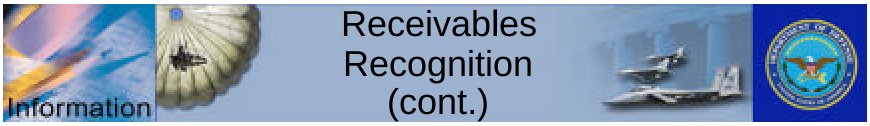
Rule	Record Series	Description	Maintained In	Cut off/Disposition/ Authority
1.	Daily Cash Accountability	Forms such as daily statements of accountability; daily summary of receipts, reimbursements and net disbursements; daily voucher control; cash collection record; daily voucher transmittal forms and related data, …	Site designated offices	Cut off at end of fiscal year in which discrepancies identified by servicing Sites have been corrected. Destroy 1 year, 1 month after cut off. AUTH: (N1-507-97-1) (7320/R1)
7.	Deposits	Certificates of deposit forms (and similar forms used for limited depositories), schedule of cancelled checks (except those covered in Rule 2), lists of checks and negotiable instruments, or copies of checks and instruments deposited, by-others chargeback /credit back listings.	Site designated offices	Cut off at end of fiscal year in which deposits have been verified or upon resolution of any outstanding adjustments. Destroy 6 years, 3 months after cut off. AUTH: (GRS 6, Item 1a) (7320/R7)

One example, is file series, or Schedule 7320, Disbursing and Collection Records.

The first listing in the schedule is the Daily Cash Accountability, that includes several accountability forms, summaries, records, and vouchers. It is required to be maintained in site designated offices, and is cut off at the end of the fiscal year in which discrepancies identified by servicing sites have been corrected. It is destroyed one year and one month after cutoff.

Another listing in the schedule is Deposit records. Deposit records include certificates of deposit forms, schedules of cancelled checks, lists of checks and negotiable instruments, or copies of checks and instruments that have been deposited. These are also maintained in site designated offices. They are cut off at the end of the fiscal year in which deposits have been verified or upon resolution of any outstanding adjustments. They are destroyed six years and three months after cut off. This listing cites GRS 6, Item 1a, as the authorizing reference for the disposition instructions.

Let’s take a closer look at where files are maintained.



Receivables Recognition (cont.)

File Location

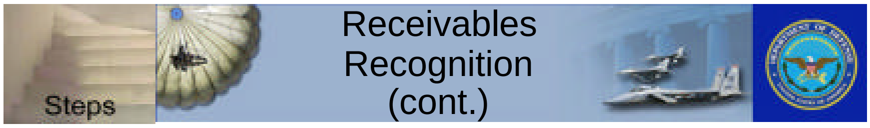
- **Hard copy files**
- **Electronic files**
- **Records**
- **Reports**

In order to be able to express an opinion on financial statements, the auditors must be satisfied that the financial statements are supported by reasonable documentation. They examine the systems and processes that execute, document, record, classify, and report Accounts Receivable transactions. These transactions are recorded in the accounting records; however, keep in mind that support for the transactions most often is with the operating organizations that initially executed the transactions. These are the site-designated offices referred to within the maintenance instructions for each series of records.

Financial statement auditors need access to the records maintained by many operational and support organizations in addition to those maintained by financial organizations. Electronic files and reports may be accessible from your location but reports may be generated at various other levels that feed the information reported on the financial statements.

Supporting documentation should be stored where it can be provided within 48 hours of the auditors request in order to meet the requirement for timely retrieval.

Let’s discuss internal control applicable to the receivables processes.



Internal Control Techniques

- **Control environment**
- **Reimbursable sales controls**
- **Cash receipts controls**

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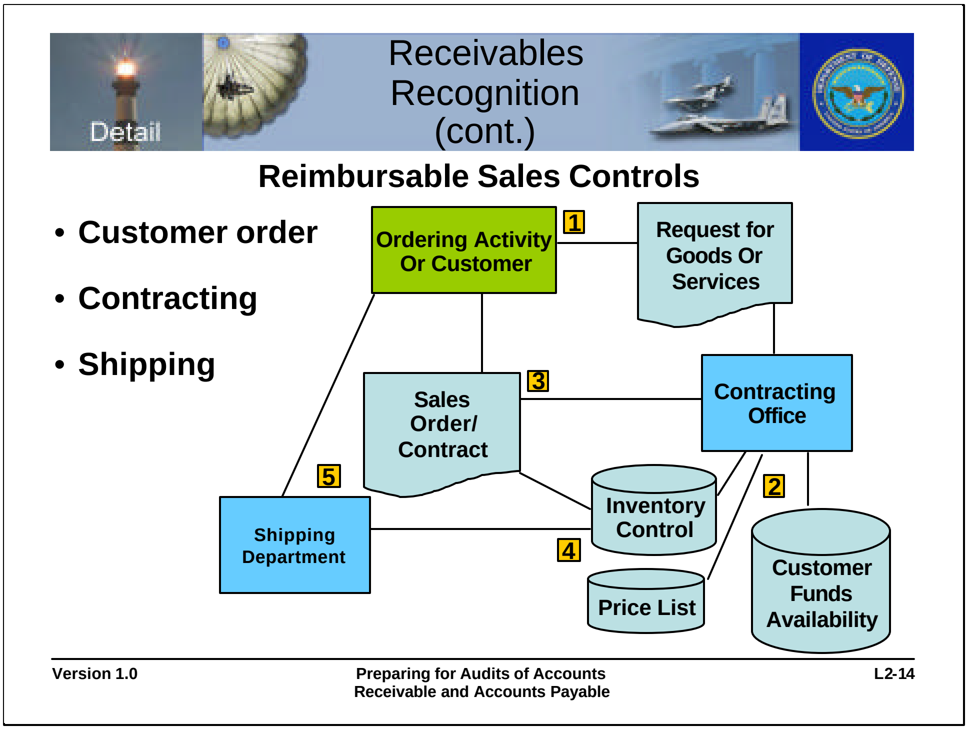
The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. It consists of all the activities, attitudes, influences, policies, and inherent risks that are associated with a particular process or cycle of activity within your entity. The control environment associated with receivables transactions includes the risk of fraudulent financial reporting through the intentional overstatement of receivables. It also includes the risk of erroneous reporting through incompetence or lack of sufficient knowledge. Indifference and inattention to detail also contribute to the risk of erroneous reporting.

These risks can be mitigated through integrity and ethical values, a management commitment to competence, management's conscientiousness and conservatism in developing accounting estimates, such as the allowances for uncollectible accounts, the assignment of authority and responsibility for affected activities, and human resource practices and policies related to personnel who handle cash receipts.

Let's look at specific reimbursable sales and cash receipts controls that are associated with receivables processes.

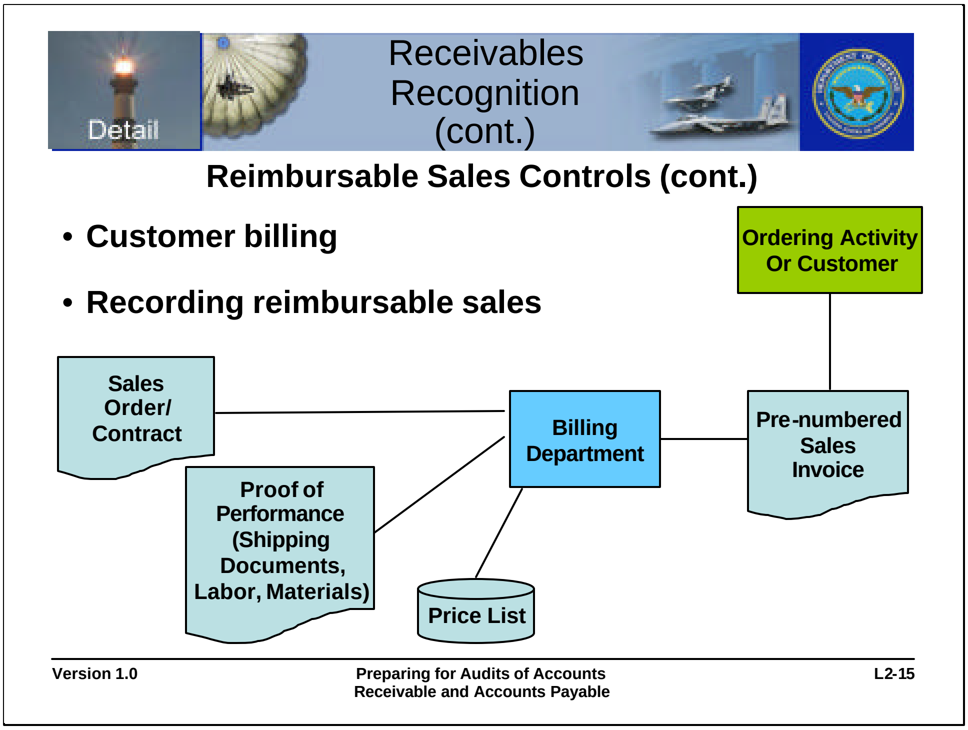


Reimbursable sales controls begin with the initial customer order. Reimbursable orders should be analyzed for customer funds availability, price, and capability of the performing activity to fulfill the order (shown as a check of the inventory). Once this criteria is met, a sales order or contract is completed which specifies the terms of the order. This may take the form of an acceptance of the initial order. A copy is furnished to the customer confirming the order, and the performing activity provides the good or service in accordance with the terms. Once the performance is complete as shown by the shipment of goods, an Account Receivable is established.

The accepted order begins the audit trail for a reimbursable sale transaction. Proof of performance is evidenced by shipping documents or other forms of performance such as billable hours. This proof of performance supports the audit trail by providing the recognition date of the receivable and the listing of goods or services provided for which the amounts are owed.

The prohibiting of the release of goods from a warehouse without an approved sales order contributes to the physical controls over the assets of your entity. The approved sales order file also supports the inventory control records that are audited as part of the Property, Plant, and Equipment audit.

Let’s continue looking at reimbursable sales controls.

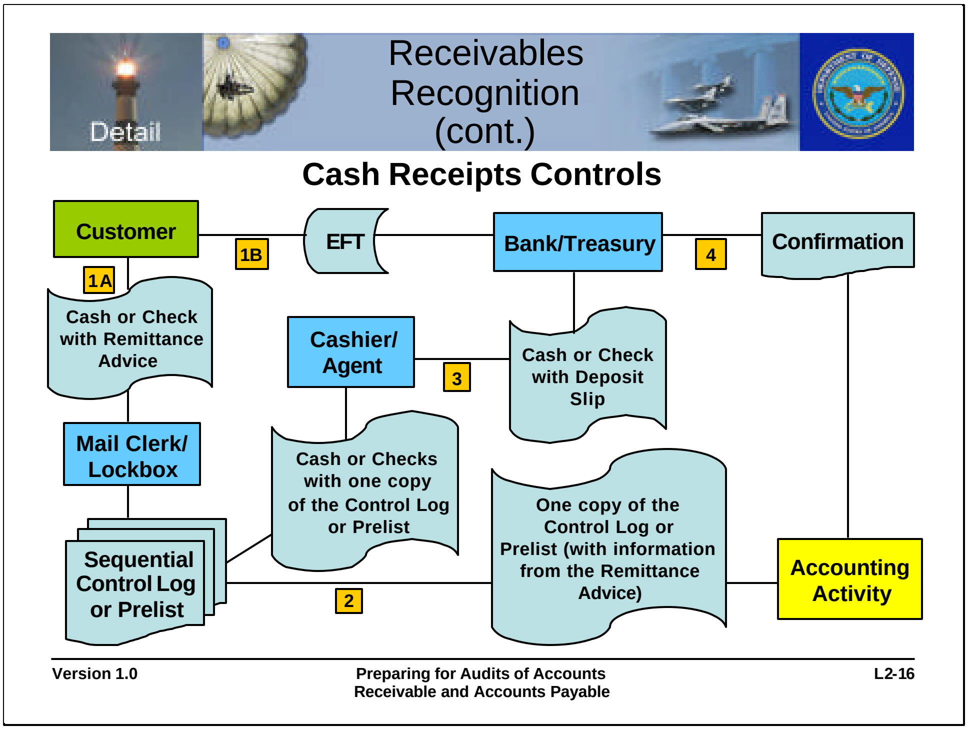


Customer billing involves sending pre-numbered sales invoices to customers. Controls should be in place to ensure that customers are billed for all shipments at authorized prices and with no duplicate billing. These controls may include an independent check by billing department personnel of the existence of a shipping document and matching approved sales order before each invoice is prepared. They include the use of an authorized price list or computerized master price file in preparing the sales invoices and manual independent checks or computer program checks on the pricing and mathematical accuracy of sales invoices. Also included are comparisons of control totals for shipping documents with corresponding totals for sales invoices.

Controls over recording include:

- recording reimbursable sales only on the basis of a sales invoice with matching shipping document and sales order evidencing the sale and transaction date
- accounting for all pre-numbered sales invoices
- checks on agreement of control totals for invoices processed and total amounts recorded
- using an appropriate chart of accounts for recording sales with independent supervisory checks or system edits
- segregation of duties for approval of the order, performance under the order, billing, and receiving funds
- restricting access to records and computerized files from unauthorized entry or manipulation
- independent checks on agreement of Accounts Receivable subsidiary ledger or master file with the general ledger control account including instructions on monthly statements to customers to report any discrepancies
- periodic performance reviews that include adherence to applicable controls.

Now let's look at cash receipts controls.



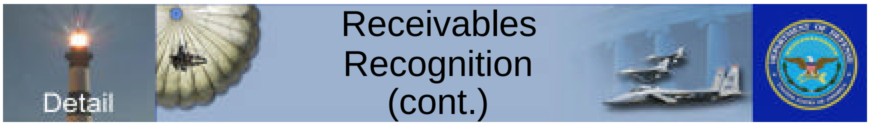
A major risk in processing cash receipts transactions is the possible theft of cash before or after a record of the receipt is made. Thus, control procedures should provide a reasonable assurance that documentation establishing accountability is created at the moment cash is received and that the cash is subsequently safeguarded. A second risk is the possibility of errors occurring in the subsequent processing of the receipts. As we are concerned with receivables transactions, these cash receipts may include cash received to redeem dishonored checks, repay advances, or for services provided by the Department. They may also include checks received through the mail, EFTs, and inter-agency transfers for reimbursable sales or other amounts owed.

When a customer remits payment, it may be received by the mail clerk or in a lockbox that is accessed by the authorized mail clerk (item 1A) or it may be submitted through an EFT directly to the designated bank or treasury account (item 1B). Cash or checks received in a mail room should immediately be stamped for deposit only and recorded on a control log or prelist (prepared in triplicate) to establish accountability for the receipts. Information from the remittance advice is annotated on the control log or prelist and one copy is forwarded to the accounting activity for use in updating receivables files. Another copy is forwarded to the cashier along with the cash or checks. The cashier/agent should deposit the cash/checks on a daily basis to the bank. A copy of the control log or prelist is also retained in the mail clerk's records. This process allows for the adequate separation of duties between the handling of cash and the recording of accounting transactions.

A lockbox may be in the form of a tamper-proof delivery slot such as the deposit slot for overnight deposits at a bank, or may be a secured box with a slot that can only be opened by designated individuals. Debtors may also be instructed to mail payments to a lockbox address which is a post office box controlled by a federal reserve bank. The bank acts as the cashier or agent and forwards the remittance information to the appropriate accounting activity.

Most debt due from the public is paid through EFT deposits. The EFT transaction should refer to the specific invoice being paid and include the customer's account information for processing. The bank forwards this information, as well as deposit information, through confirmations to the accounting activity for the proper credit to the customer's account. Accounting should then reconcile the amount deposited with the listing received from the mail clerk and ensure that they account for any differences.

Controls include restricted access to cash and deposits, sequential control logs or prelists, supervisory surveillance, and independent checks on the accuracy of cash count sheets by supervisory personnel. Let's continue looking at cash receipts controls.



Receivables Recognition (cont.)

Cash Receipts Controls (cont.)

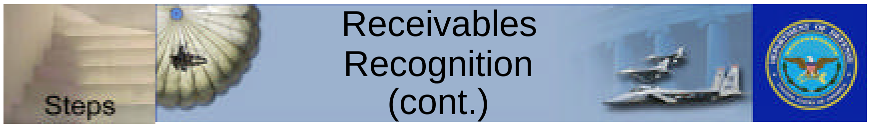
- **All receipts deposited intact daily**
- **Restricted access to computer files**
- **Separation of duties**
- **Independent checks of agreement between posted amounts, prelists, cash summaries, and deposit slips**

Proper physical controls over cash require that all cash receipts be deposited intact daily. Intact means that cash disbursements should not be made out of undeposited receipts. This control reduces the risk that receipts will not be recorded and the bank deposit record establishes the existence or occurrence of the transaction. Checks received in the mail should agree with accompanying sequential control logs or prelists. Totals are then listed on the daily cash summary and forwarded to accounting along with the validated deposit slip.

Recording controls should ensure that only valid receipts are entered and that all actual receipts are entered at the correct amounts. Access to computer files should be restricted to authorized personnel and receipts should be posted from the daily cash summary. The receipt of cash or checks should be segregated from posting to accounting records.

To ensure completeness and accuracy of recording mail receipts, independent checks of agreement are made of the amounts journalized and posted with the amounts shown on the control logs or prelists received from the mailroom, the total amounts journalized in the daily cash summary, and validated deposit slips received from the cashier. In addition, periodic bank reconciliations (reconciliation with Treasury) should be performed by an employee not otherwise involved in executing or recording cash transactions.

Let’s discuss SOPs.



Receivables Recognition (cont.)

Standard Operating Procedures

- **Responsibility**
- **Currency**
- **Uses**

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SOPs are interpretations of guidance that are written for the first-line user. An SOP written for the first-line user in the receivables process would include instruction on specific procedures for processing payments received, customer billing, reconciliation of receivables balances, and other procedures used within the receivables section. It should also include internal control and identify responsibilities and authority.

It is the responsibility of the first-line supervisor to ensure that this guidance is available, current, and applicable to the tasks that must be accomplished. This does not mean that the first-line supervisor needs to re-invent the wheel. It means that the supervisor needs to review the guidance available for the assigned tasks and ensure that it is current, sufficient, applicable, and read by staff members.

If available guidance is not sufficient or not current, then the supervisor must address those areas that are not adequately covered or are outdated. Some SOPs include a reading list that must be completed by staff members based on their specific duties. You may include some method of ensuring that the applicable guidance is read and understood.

Let's move on to the Debt Collection Process.

Debt Collection Process

Delinquent Accounts Receivables are receivables that have not been paid by the date specified.

- **Debt Collection Improvement Act (DCIA)**
- **Estimating the Allowance for Uncollectible Accounts**
- **Aging of receivables accounts**
- **Debt collection processes**

DCIA: http://www.fms.treas.gov/news/factsheets/dcia.html

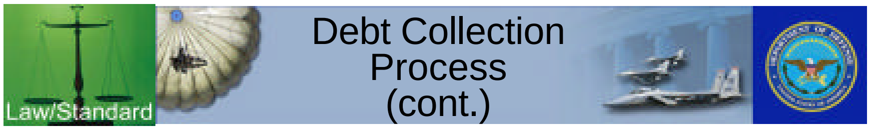
Delinquent Accounts Receivable are receivables that have not been paid by the date specified in the initial written demand for payment or applicable agreement or instrument.

In this topic, you are exposed to the provisions of the DCIA, the estimation of an Allowance for Uncollectible Accounts, aging of receivables accounts, and the debt collection processes instituted within the DoD.

We discuss the identification of problem debts and the provisions for estimating the true value of existing receivables and then look at aging of receivables accounts and how the aging of these receivables identifies problem debts and allows for a better estimation of the true value of existing receivables.

In looking at the debt collection processes, we examine stopping points, decision points, systems, and reports, to graphically depict the process.

Let's begin with a look at the DCIA.



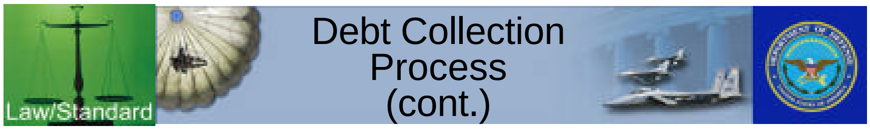
The Debt Collection Improvement Act

- **Centralized debt collection operations for the federal government**
- **Delinquent (over 180 days)**
- **Cross-servicing program**

Due to an increase in the amount of non-tax debt, and concern about the collection of that debt, Congress passed the DCIA. This law centralized government-wide collection of delinquent (over 180 days) debt and gave the Financial Management Service (FMS) of the Treasury the responsibility for implementation of the debt collection provisions of the DCIA. Federal agencies are required to refer eligible delinquent non-tax debts to the Treasury or another Debt Collection Center for debt collection action if they have not been successful at collecting those debts. The types of debts referred to the FMS include unpaid loans, overpayments or duplicate payments made to federal salary or benefit payment recipients, misused grant funds, fines, penalties, or fees assessed by federal agencies.

Cross-servicing is the process whereby federal agencies refer delinquent debts to the Treasury for collection. The referring agency retains responsibility for reporting the debts and for removing accounts from its receivables when the Treasury directs it to write off the debt. In order to effectively collect the debts that agencies refer, the Treasury issues demand letters, conducts telephone follow-up, initiates skip tracing, refers debts for administrative offset, performs administrative wage garnishment, and refers debts to private collection agencies on the debt collection contract.

One of the tools used by the FMS to collect debts is the Treasury Offset Program (TOP). Let's discuss this program.



Debt Collection Process (cont.)

The Debt Collection Improvement Act (cont.)

- **Treasury Offset Program (TOP)**
- **Requires referral of non-tax debt**
- **Disbursing officials compare payment information with debtor information in the FMS delinquent debtor database**

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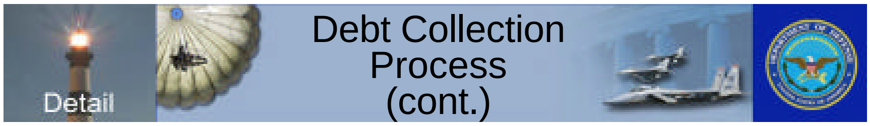
The TOP is a centralized offset program, administered by the FMS's Debt Management Services. States and federal agencies submit delinquent debts to the FMS for collection and inclusion in the TOP and certify that such debts qualify for collection by offset. The TOP compares the names and Taxpayer Identification Numbers (TINs) of debtors with the names and TINs of recipients of federal payments. If there is a match, the federal payment is reduced, or offset, to satisfy the overdue debt. The DCIA requires federal agencies to refer delinquent non-tax debt to the FMS for purposes of collection by offset of non-tax payments. Non-tax payments include vendor, federal retirement, federal salary, and Social Security benefits.

As the DoD is authorized to disburse federal funds, disbursing officials must compare payment information on certified payment vouchers to debtor information, which has been supplied by the creditor agency, in the FMS's delinquent debtor database. If the payee's name and TIN match the name and TIN of a debtor, the disbursing official offsets the payment in whole or in part to satisfy the debt to the extent legally allowed.

Let's look at the requirement for recognizing losses on uncollectible accounts by examining the estimation of an allowance for uncollectible accounts.



Debt Collection Process (cont.)

Estimating the Allowance for Uncollectible Accounts

- **Significant accounts**
- **Groups of accounts**
- **Risk factors**
- **Disclosure**

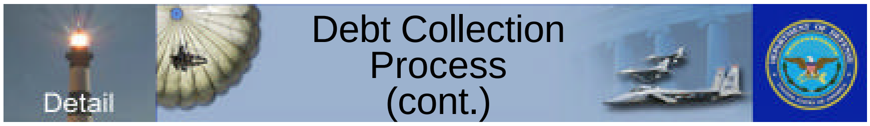
According to SFFAS No. 1, losses on receivables should be recognized when it is more likely than not that the receivables will not be totally collected. An allowance for estimated uncollectible amounts is set up to reduce the amount of the receivables to their estimated net value. A systematic methodology is used to estimate losses based on analysis of both individual accounts and groups of accounts. This allowance for uncollectible amounts is re-estimated for each annual financial reporting period and when information indicates that the latest estimate is no longer correct. The estimate is then signed by the Accountable Officer.

Accounts that represent significant amounts should be individually analyzed to determine the loss allowance based on the debtor's ability to pay, the debtor's payment record and willingness to pay, and the probable recovery of amounts from secondary sources, including liens, garnishments, cross-servicing program collections, and other applicable tools.

To determine the loss allowance on a group basis, receivables are separated into groups of homogenous accounts with similar risk characteristics, such as debtor categories (business firms, state and local governments, or individuals), reasons for indebtedness (erroneous benefit payments, trade accounts, defaulted loans), geographic regions (foreign or domestic), or other groupings. They are further categorized by risk factors such as economic stability, payment history, alternative repayment sources, and aging of receivables.

Historical loss experience, recent economic events or current forecasts, and inherent risks are also used in the calculation of appropriate allowance accounts for uncollectible receivables. Notes to the financial statements should disclose the major categories of receivables by amount and type, methodology used to estimate the allowance for uncollectible amounts, and the total allowance.

Let's continue our examination of the estimation of an allowance for uncollectible accounts.



Estimating the Allowance for Uncollectible Accounts (cont.)

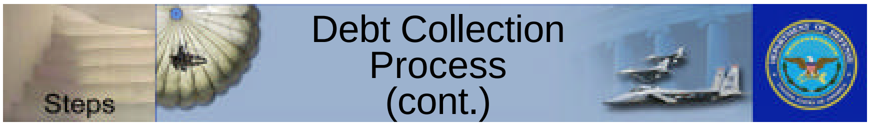
- **Review for validity**
- **Begin collection efforts**
- **Analysis of uncollectible accounts**

When a receivable has not been paid at the appropriate due date, the account is analyzed to ensure that it is a valid receivable. If it is determined that a debt was never owed and should not have been classified as an Accounts Receivable, the entries that established the receivable should be reversed. If a billing agency does not have or cannot produce the evidence necessary to establish a claim and has not been able to obtain the voluntary repayment of the debt, the entries that established the Accounts Receivable should also be reversed.

Receivables are reviewed for completeness, accuracy, and supportability, on a tri-annual basis during each of the four month periods, ending on January 31, May 31, and September 30, of each fiscal year. If a receivable is found to be erroneous or unsupportable, it is no longer classified as a receivable.

Once the validity of the debt has been established, collection efforts begin, and the receivable account is analyzed. The methodology used for this analysis is based on both individual accounts and groups of accounts as we discussed earlier. Results of this analysis provides the basis for estimating the required balance in the Allowance for Uncollectible Accounts.

A general reserve method of estimating uncollectible amounts is based on the principle that the more delinquent an Account Receivable becomes, the greater the likelihood that it will not be collected in full. The analysis of receivables by age groups can be used in determining a reasonable amount to add to the allowance for loss on accounts and refunds receivable. Let's examine this process.



Example of Aging of Receivables

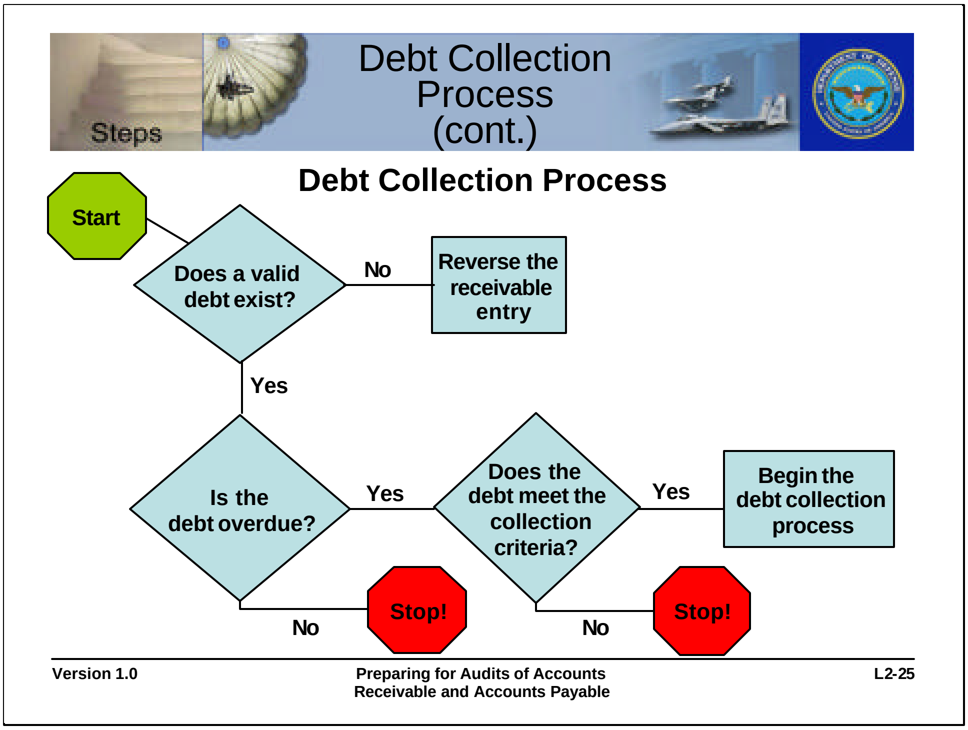
AGED ACCOUNTS RECEIVABLE GROUPS		
CATEGORY	Intragovernmental	Nonfederal
Nondelinquent		
Current		
Noncurrent		
Delinquent		
1 to 30 days		
31 to 60 days		
61 to 90 days		
181 days to 1 year		
Greater than 1 year and less than or equal to 2 years		
Greater than 2 years and less than or equal to 6 years		
Greater than 6 years and less than 10 years		
Greater than 10 years		
Note – Non delinquent accounts receivable are receivables not yet due under the contract or billing document pertaining to the receivable. Current nondelinquent accounts receivable are those that are due in the next 12 months. Noncurrent nondelinquent accounts receivable are those amounts that are due beyond the next 12 months. Delinquent accounts receivable shall be aged from the date the account is considered delinquent as outlined in paragraph 030206 of this chapter.		

Receivables are aged from the recognition date (date of receipt of goods or services). The due date for a receivable is normally 30 days from the date of invoice or notice of payment due, unless a specific due date is established by statute, contract provision, or notice of indebtedness. Invoicing should be accomplished as soon as possible after the recognition date.

If a payment grace period is provided and expires without payment, then the receivable becomes delinquent from the original payment due date or date of notification. When a payment agreement allows the activity to declare the full amount of the account due, and the activity has done so, then the entire amount of the account or loan and related interest and penalties, if any, are reported as delinquent. Accounting systems should be designed to accumulate and record interest, penalties, and administrative charges as they accrue. Payments are applied first to outstanding penalties, second to administrative charges, third to interest, and last to principal.

To determine the amount of potentially uncollectible Accounts Receivable, it is desirable to estimate the percentage of probable expense for each age group of receivables. This percentage, when applied to the dollar amount in each age group, gives a probable expense for each group. By adding together the probable expense for each group, the required balance in the allowance account is determined.

Using the group categories, we have calculated the probable expense for a sample allowance account. Notice that the group amount decreases while the percentage of probability increases as the period of delinquency increases. This trend is typical if your collection efforts are effective. Let’s consider the debt collection process.

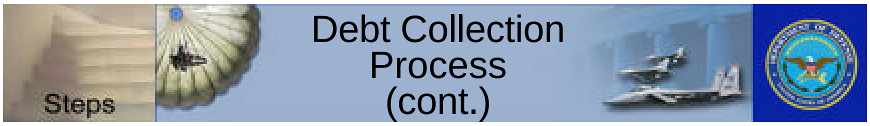


Except for debt from foreign countries, accounting and collection procedures are designed to provide information to assist in determining realistic points of diminishing returns beyond which collection efforts are not justified, and the minimum amount of a debt when no collection action at all should be undertaken. Procedures used should include the cost of the collection effort, and a comparison should be made at least annually of collection costs against amounts collected. Reviews of debt type, size, and age are also used to evaluate the collection effort.

According to Office of Management and Budget (OMB) Circular A-129, Policies for Federal Credit Programs and Non-Tax Receivables, (Section 5. Termination of Collection, Write-Off, Use of Currently Not Collectible (CNC), and Close-Out), generally, a write-off is mandatory for a public delinquent debt that has not been collected within two years, unless a waiver is requested that documents and justifies the retention of the receivable. The waiver is submitted to Office of the Undersecretary of Defense (Comptroller) (OUSD(C)) for coordination with OMB and the Treasury. Once the debt is written-off, it is classified as CNC or closed out. CNC debts are eligible for both offset and cross-servicing. Public debt is classified as CNC only if: (1) the vendor debt is over \$600 or the individual out-of-service debt is over \$225, (2) all Component debt collection actions have been pursued, (3) it is not cost effective to continue collection efforts, and (4) the debt is less than two years old, unless exempted.

The debt collection process includes: (1) the preparation of the initial demand letter, (2) all follow-up actions such as answering rebuttals, processing requests for waiver or remission, holding hearings, negotiating compromises, handling installment contract and suspense, processing collections, and making referrals to credit reporting and collection agencies, and (3) the completion of the case, including maintaining the case file information until the appropriate statute of limitations expires.

Let’s take a closer look at some of the debt collection actions.



Debt Collection Criteria

- **Individual debt**
- **Vendor debt**
- **Age of debt**
- **Amount of debt**

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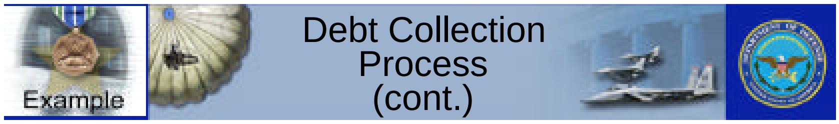
The demand letter is issued by the DoD Component or paying office (entitlements office) and includes the basis of indebtedness, the amount, a complete explanation of the debtor's rights and responsibilities, and additional charges that may be levied. It also includes the Point of Contact (POC) and payment information, and lists remedies that the Department will use to enforce payment. On overpayments, the paying office, the DO, or the contracting officer may issue the demand letter.

For individual out-of-service debt, these remedies may include federal salary offset, assessment of interest, penalties, and administrative costs, allotments, collection of collateral, credit bureau reporting, wage garnishment, collection agencies, collection through the Department of the Treasury, and litigation. Debts of $225 or more are transferred to the DFAS-Denver Debt and Claims Management Office (DCM) for servicing within the Defense Debt Management System (DDMS) when the individual leaves service and all required Accounts Receivable billing and follow-up action has been completed.

For vendor debt, DOs are responsible for collecting the amount of an overpayment resulting from an erroneous payment, duplicate payment, or dual negotiation of an original and recertified U.S. Treasury check. In the case of a contract modification that causes an overpayment, it is the responsibility of the Procurement or Administrative Contracting Officer to ensure that the demand letter is sent for recovery of funds. For most types of contract debts, the contracting officer has the primary responsibility for determining the amounts of and ensuring collection of the debt. Delinquent vendor debt of $600 or more is submitted to the DFAS-Columbus, Debt Management Office (DMO) for servicing through the Contract Debt System (CDS) no later than 90 days after the payment due date.

Let's look at an example of the Commercial Debt Accounts Receivable Write-off Process.



Commercial Debt Accounts Receivable Write-off Process

Write-off Coordination between Accounting and Fund Holder

- **For debts less than $600:**
  - ✓ **After 90 days, accounting notifies Fund Holder of intention to write-off asking for their concurrence.**
  - ✓ **If Fund Holder non-concurs within 60 days, written evidence of collectability must be provided.**
  - ✓ **Last attempt is made. If payment is not received within 180 days from original bill date, receivable is W/O.**
- **For debts over $600:**
  - ✓ **After 90 days, refer to DMO for contractor debt and DDMS for individual debt. DMO and DDMS refer to Treasury at 180 days. After Treasury due process, write-off coordinated with Fund Holder no later than two years.**

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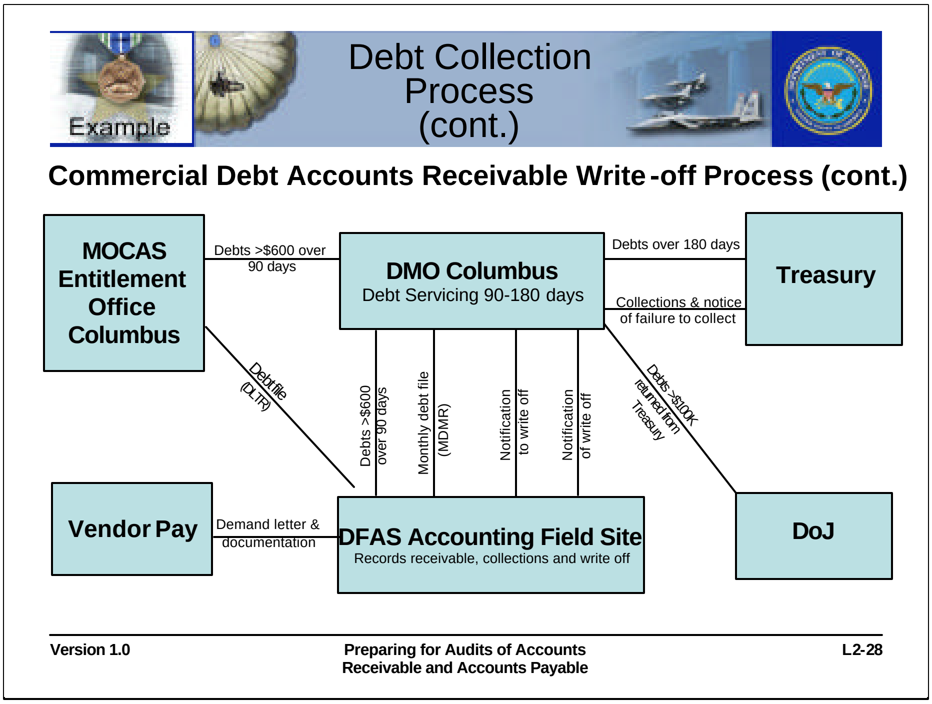
Collection efforts continue until 90 days have elapsed from the initial due date. If the debt is greater than $600, the accounting field site forwards the complete debt file to the Columbus DMO. If the debt is less than $600, the accounting field site notifies the fund holder of their intention to write off the debt. The fund holder has 60 days to respond with written evidence of collectability, or concurrence with the write-off. If there is no response, the accounting field site will write off the debt. A last attempt is made to collect the debt that the fund holder has evidenced as collectible. If payment is not received within 180 days from the original due date, the receivable is written off and the fund holder is notified of the write-off.

After the Treasury has made an attempt to collect the debt through their due process, and before two years have elapsed from the original payment due date, a notice of failure to collect on the debt is sent to the DMO if the debt collection was unsuccessful. If collection efforts are successful, evidence of collection is forwarded to the DMO for entry into applicable accounting files.

Let's illustrate the commercial debt management process.

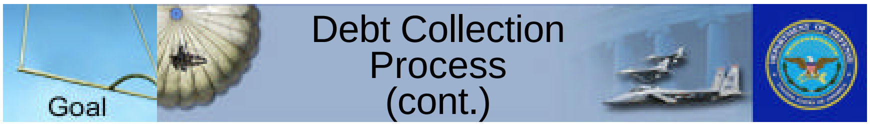


Notice that contractor debt files may originate in the Columbus Entitlement Office or in servicing vendor pay offices. Once the demand letter has been sent to the vendor and initial collection efforts have failed to result in payment of the outstanding debt, the debt case file is forwarded to the accounting field site along with the Mechanization of Contract Administration Services (MOCAS) Demand Letter Tracking Report (DLTR).

The DMO continues collection efforts until the debt is 180 days old. Public receivables over 180 days old are transferred to the Treasury for further collection action except when debts or claims are in litigation or foreclosure; will be disposed of under an asset sales program within one year after becoming eligible for sale, or later than one year if consistent with an asset sales program; have been referred to a private collection contractor for collection for a period of time determined by the Secretary of the Treasury; or will be collected under internal offset, if such offset is sufficient to collect the claim within three years after the date the debt or claim is first delinquent.

If the uncollected debt is greater than $600, but less than $100,000, a determination is made to write off the debt. Notification to write-off is sent to the DFAS accounting field site. The accounting field site writes off the debt in coordination with the fund holder and sends notification of write-off back to the DMO. This ensures that the Monthly Debt Management Report (MDMR) that identifies debt at the transaction level is in agreement between the two entities. Reconciliation of MDMR is the responsibility of the DFAS field site. Debts due from the public that are $100,000 or more must be referred to the Department of Justice (DoJ) for concurrence to terminate collection action.

Let’s examine our goals for debt collection.



Financial Highlights

The FY 04 goal of reducing delinquent receivables by 25 percent resulted in public receivables decreasing by 21 percent and intra-governmental receivables decreasing by 16 percent.

In 2003, the Department set several goals or metrics for FY 04 to focus on solving problems with delinquent debt.

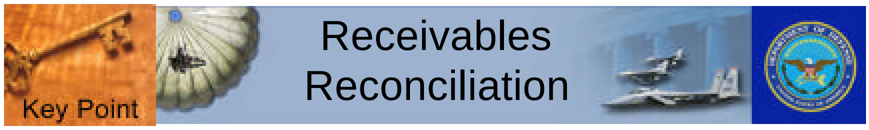
Metric 1, Total Delinquent Accounts Receivable Available For Collection, requires a 25 percent reduction in the amount of DoD delinquent Accounts Receivable (public and intra-governmental included).

Metric 2, Public Accounts Receivable Requiring Due Process Residing at Field Level Greater Than 180 Days, requires a 25 percent reduction in amount.

Metric 3, Reduction of Public Debts Residing in the Debt Management Systems such as CDS (DFAS-Columbus) and DDMS (DFAS-Denver), requires a 25 percent reduction in amounts.

The result of this change in focus was a decrease in public receivables by 21 percent and intra-governmental receivables by 16 percent.

Now let's consider the reconciliation of receivables.



Receivables Reconciliation

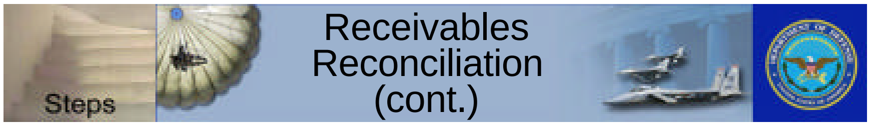
Benefits of Reconciliation

- **Funds accountability**
- **Accurate reporting for audit**
- **Accurate reporting for management purposes**
- **Receivables reconciliation process**

There are many benefits to the reconciliation of receivables. The receivables reconciliation process is important because funds accountability remains with the fund holder even when the debt is transferred to Columbus or Denver for collection action or follow-up.

In relation to the audit of Accounts Receivable, it is of the fund holder that the auditor will request information on the receivables that they report. From a management perspective, you must know the status of your receivables to determine the funds availability for future action.

Let's look at the receivables reconciliation process.



Receivables Reconciliation (cont.)

Reconciliation Process

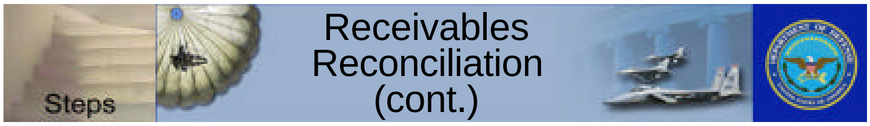
- **Review Requirements**
- **Duties and Responsibilities**
- **Reconciliation Reports**

Receivables are reviewed for supportability and validity. Such reviews are part of the Triannual Reviews of Commitments and Obligations conducted by fund holders with assistance from supporting accounting offices. Fund holders are DoD officials that receive a documented administrative subdivision of funds.

Accounting offices provide listings or automated media identifying Accounts Payable and Accounts Receivable, which enables the fund holder to reconcile the accounts and to verify their validity and accuracy. The transaction media should allow for the annotation of individual transactions for further action if the review reveals that requirement.

The Accounting Office assists in the review and reconciliation process by providing transaction groupings by organizational segment, identification and correction of situations that may delay recording of commitments or obligations, or the matching of disbursements to obligations; and entering corrections identified by the fund holder when such corrections are adequately documented and their entry is the normal function of the Accounting Office.

Let's look at the duties and responsibilities of those involved in the review and reconciliation process, beginning with the Accounts Receivable Office (ARO).



Receivables Reconciliation (cont.)

- **Accounts Receivable Office (ARO) responsibilities**
- **Debt Management Office (DMO) responsibilities**
- **Debt and Claims Management Office (DCM) responsibilities**

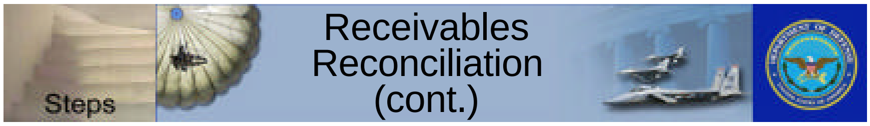
CONOPS for Managing Accounts Receivable: http://www.dfas4dod.dfas.mil

According to the DFAS Concept of Operations (CONOPS) for Managing Accounts Receivable, dated August 2003, the ARO is the office responsible for managing receivables to include collection actions and/or the recording and reporting of receivables. In most cases, the ARO is located in a DFAS Accounting Office, entitlement or debt management office. The ARO is responsible for preparing the package for transfer to debt collection services and managing the receivable until such time as it is either collected, written off, or adjusted. These efforts are supported by the entitlement offices, the DMO, the DCM, and the fund holder.

The DMO at DFAS-Columbus performs a variety of debt management functions associated with delinquent contractor Accounts Receivable. When the ARO or the Contract Pay Product Line refers a delinquent receivable to DMO for collection, the ARO remains accountable for maintaining the receivable subsidiary and general ledger balances. Thus accountability remains with the field site for public contract/vendor pay receivables. The DMO provides sufficient detail on a monthly basis for reconciliation to the detail records.

The DCM at DFAS-Denver is responsible for managing individual out-of-service Accounts Receivable. DCM performs a variety of receivable collection functions including the quarterly reporting of Accounts Receivable data and the monthly reporting of collections to the appropriate DFAS department level accounting for input to the general ledgers.

Now let's look at the responsibilities of the fund holder.



Fund Holder Responsibilities

- **Conduct tri-annual and annual reviews**
- **Year-end certification**
- **Maintain records of reviews**
- **Manage receivables**

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Fund holders are responsible for the conduct of reviews as they are in the best position to determine the accuracy and the status of their transactions. Reviews are accomplished no later than 14 days following the end of January and of May, as well as by September 30, of each fiscal year.

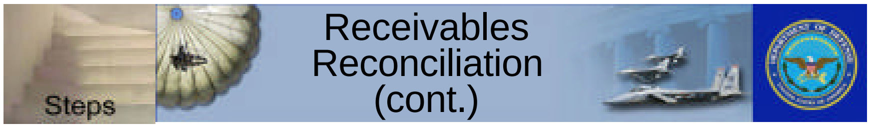
These Tri-Annual Reviews have dollar thresholds which require the review of items exceeding certain dollar amounts such as $50,000 for O&M accounts and $200,000 for Investment accounts. Most transactions fall below these threshold amounts and fail to be reviewed in a timely manner. However, the requirement states that a 100% review must be performed at least once a year.

In reviewing goods or services received or provided, accrued expenditures or accrued earnings are reconciled with related Accounts Payable and Accounts Receivable accounts. If, based on the receipt of goods or services, it appears that an outlay transaction should have been received but is not recorded, the paying/collecting office is contacted to determine the status of the transaction. Unsupportable receivables should be removed.

All commitments and obligations not meeting the requirements for triannual review are reviewed at least annually in order to substantiate a year-end certification requirement by the fund holder. Fund holders are required to maintain, for a period of 24 months following the completion of the review, documentation that is sufficient to permit independent organizations, such as the DoD OIG, or DoD Component Audit Agency/Service or Inspector General, to verify that the reviews were accomplished as required.

Public receivables under review by the DoJ, and debt in the process of being collected, are exempt from tri-annual review requirements. However, such exempt debt must be aggressively managed and monitored for status of collection by the responsible Accounting Office. The bottom line is that all receivables are required to be supported.

Let's look at the responsibilities of the performing entity.



Receivables Reconciliation (cont.)

Performing Entity Responsibilities

- **Research abnormal balances**
- **Verify billings**
- **Ensure availability of supporting documentation**
- **Research Unmatched Disbursements (UMDs) and Negative Unliquidated Obligations (NULOs)**
- **Balance receivables and collections with accrued expenditures paid and unpaid**

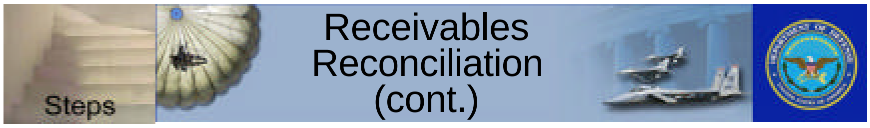
The performing entity should research any abnormal unfilled customer order balances; such balances indicate that an order may not be recorded. They should also research any abnormal filled customer orders uncollected balances; such balances indicate that collections may have been incorrectly recorded.

They should obtain billing transaction histories from the ARO to ensure that billings are against the correct order and, consequently, billed against the correct obligation. Billing transaction histories should be provided within 30 days. They should also request copies of documents supporting that a payment is due and reconcile these documents with the related Accounts Receivable. Any discrepancies should be resolved by adjusting the Accounts Receivable to the appropriate amounts.

The performing entity should research Unmatched Disbursements (UMDs) and Negative Unliquidated Obligations (NULOs). Duplicate payments and overpayments, such as refund receivables, should be obligated within 100 days if co-located, and within 130 days if non co-located.

They should balance the receivables and collections (earnings) relating to the reimbursable program of the performing activity with the accrued expenditures paid and unpaid of the same performing entity.

Let’s look at the required reports.



Monthly Debt Management Report (MDMR)

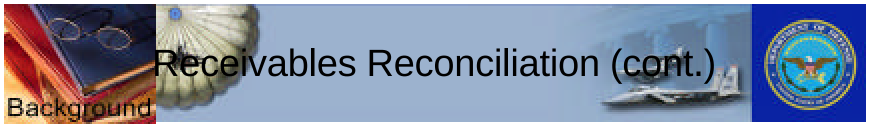
- **Provided by the DMO at Columbus**
- **Reconciled with the general ledger, the Treasury Report on Receivables (TROR) Due from the Public, and the MOCAS Demand Letter Tracking Report (DLTR) on a monthly basis**
- **Debts are listed until resolved**

The DMO at Columbus maintains contractor receivables records contained in the Contractor Debt System (CDS). These records provide the current status of receivable balances provided to field sites on the MDMR. The DMO acknowledges receipt of the debt referral and provides the MDMR from CDS to the ARO via e-mail.

The ARO reconciles the MDMR to the general ledger balances recorded for receivables on a monthly basis. They also reconcile the MDMR to the Treasury Report on Receivables (TROR) Due from the Public, and reconcile the MOCAS DLTR to the general ledger on a monthly basis. Debts listed on the MDMR are maintained on the report until the debt is resolved. The field site retains the receivable until a collection or write-off occurs.

Once approval to write off an uncollectible Accounts Receivable is authorized, the field site records the general ledger entries. A copy of the recorded journal voucher is then forwarded to the DMO for their internal processing. The MDMR for the following month will reflect the amount of the write-off. The previous month's receivable termination amount for the appropriation should now be recorded in the write-off column and will remain there for the fiscal year. It is paramount that the subsidiary ledgers and the accounting systems are in agreement.

Now let's look at the Monthly Receivables Report (MRR).



Monthly Receivables Report (MRR)

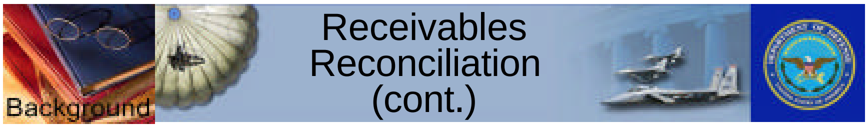
Your Entity	Non-Delinquent						Delinquent Accounts Receivable			
	Current		Non-Current		Total		1-90 days		91-180 days	
Debt Status	Count	$	Count	$	Count	$	Count	$	Count	$
Total Public-Net of Write-Offs	20	$200,000	2	$10,000	22	$210,000	11	$300,050	3	$150,000
Less: In Litigation	0	$0.	0	$0.	0	$0.	1	$20,000	0	$0.
In Bankruptcy	0	$0.	0	$0.	0	$0.	3	$170,000	0	$0.
In Dispute	0	$0.	0	$0.	0	$0.	1	$10,050	1	$30,000
At Dept of Treasury	0	$0.	0	$0.	0	$0.	0	$0.	0	$0.
At Dept of Justice	0	$0.	0	$0.	0	$0.	0	$0.	0	$0.
Indiv. Out of Service (DDMS)	0	$0.	0	$0.	0	$0.	1	$20,000	0	$0.
Contractor Debt (CDS)	0	$0.	0	$0.	0	$0.	2	$40,000	2	$120,000
Total Delinquent Debt Actively Being Pursued by Accounting	20	$200,000	2	$10,000	22	$210.000	3	$40,000	0	$0.

The MRR is a monthly receivable report prepared by the field sites that shows receivables by category and age. A Department-wide consolidated MRR is prepared by DFAS-Arlington from the consolidated reports of the DFAS Centers. The DFAS Centers reconcile the MRR to the TROR, to the audited financial statements, and to the Federal Agencies' Centralized Trial Balance System (FACTS I) quarterly. Any differences are disclosed on the financial statements and the TROR. Field sites reconcile the subsidiary ledgers to the General Ledger Trial Balance, the MRR data, and the TROR to ensure that all reports balance.

Fund holders confirm that all reimbursements and other income earned have been validated to an Accounts Receivable record or an Electronic Data Interchange (EDI) source document. They also confirm which adjustments and corrections have been taken to remedy noted problems. Any adjustments or corrections identified during reviews must be processed within 10 days to include the removal of erroneous and unsupportable receivables. Reports summarize, by type, the actions or corrections remaining to be taken and when such actions/corrections are expected to be completed. It is important when reconciling receivables transactions awaiting final determination are identified by type or category, and are monitored for final determination.

Component client executives, except for Cleveland field sites, certify the accuracy and completeness of the MRR, TROR, and audited financial statements. Cleveland Field Sites certify the accuracy and completeness of the Accounts Receivable Single Source Submission Report (ARSSSR).

Now let's look at the requirements for the TROR.



Receivables Reconciliation (cont.)

Treasury Report on Receivables Due From the Public

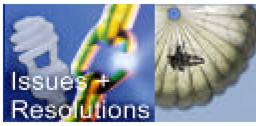
- **Used by the Treasury to determine the federal government's non-tax debt**
- **Informs federal decision makers of the gross book value of debts and actions taken to enforce collection**
- **Required by the Treasury**
- **Disseminated to Congress, OMB, Federal Credit Policy Working Group, and federal and state organizations**

TROR: http://www.fms.treas.gov/debt/dmrpts.html

The TROR is a quarterly report of receivables that provides a means for collecting data on the status and condition of the total receivable portfolio owed from non-federal sources. Full instructions for completing the TROR are located within the Treasury's Financial Management Service web site.

It is used by the Treasury to determine the federal government's non-tax debt. It also informs federal decision makers of the gross book value of debts and actions taken to enforce collection. Information from the TRORs received from federal entities are compiled by the Treasury and disseminated to Congress, the OMB, the Federal Credit Policy Working Group, and federal and state organizations.

Let's look at some current issues and resolutions that are related to receivables reconciliation.



Receivables Reconciliation (cont.)

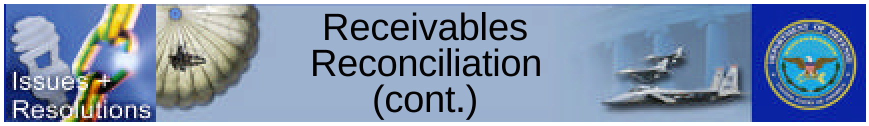
Weaknesses

- **Non-compliance with policies and procedures**
- **Non-reporting of receivables**
- **Inability to reconcile receivables**

Weaknesses exist in the Department’s Accounts Receivable management. These deficiencies apply to public and intra-governmental receivables from both general and working capital funds. The Department’s weaknesses include:

- non-compliance with policies and procedures - For example, referral of debt to Centralized Debt Management operations after 90 days, Treasury after 180 days, and write-off after two years, as appropriate
- non-reporting of receivables due to lack of controls that fail to ensure that all entitlement system receivables are recorded in the accounting systems and are supportable at the transaction level
- inability to reconcile among the balances reported on the financial statements, TROR, and DoD’s Accounts Receivable Report.

Now let’s look at the solutions.



Receivables Reconciliation (cont.)

Solutions

- **Monthly monitoring of metrics**
- **Quarterly status updates**
- **Updated SOPs**
- **Random reviews**
- **Coordinate workarounds for system deficiencies**

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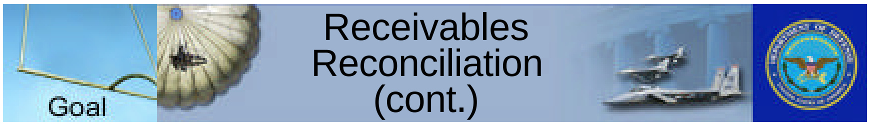
The solutions are that the Department is now:

- monitoring the monthly Office of the Secretary of Defense (OSD) Accounts Receivable metrics and providing quarterly status briefings to the OUSD(C)
- updating the Accounts Receivable operating procedures for the Department
- conducting random reviews to verify compliance with policy and procedures
- developing workarounds for the lack of entitlement and debt system interfaces to ensure proper recording and aging of receivables
- coordinating with the entitlement managers to implement necessary reporting requirements to account for the debts in their systems.

Let’s examine the goals that have been established for the reconciliation and reporting on receivables.



Reconciliation Goals

Accounts Receivable data between three different DoD/Treasury reporting sources (DDRS audited financial statements, TROR, and MRR) should be the same (within two percent).

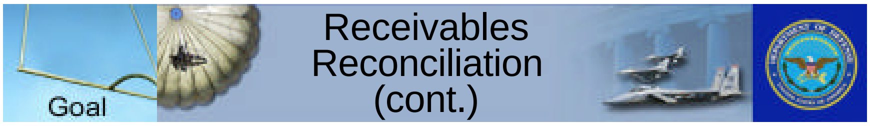
Long term (FY 2005 and beyond) goal: DDRS audited financial statements, TROR, and MRR are to be fully reconciled.

The goal for Accounts Receivable Reconciliation is to compare the Gross Public Receivables on the DDRS audited financial statements, TROR, and MRR. It requires that there should be no more than a 2 percent reconciliation amount difference from the gross public receivables reported on the financial statements to those reported on the MRR.

It also involves a comparison of Debt Amounts Eligible To Be Transferred to Treasury on TROR to the MRR. It requires that there should be no more than a 2 percent reconciliation amount difference from amount reported on the TROR as debts eligible to be transferred to Treasury versus the amount reported on the MRR.

The long term goal requires the DDRS audited financial statements, TROR, and MRR to be fully reconciled.

Let’s look at the OSD metrics for collection of receivables.



OSD Metrics

- **Delinquent Accounts Receivable available for collection by DoD**
- **Public Accounts Receivable requiring due process residing at field level**
- **Reduction of public debt greater than 180 days residing in the Debt Management System**

Government-wide Metrics

- **Delinquent Accounts Receivable from public greater than 180 days (no more than 10% can be > 180 days)**
- **Delinquent Intra-governmental receivable greater than 180 days (no more than 10% can be > 180 days)**

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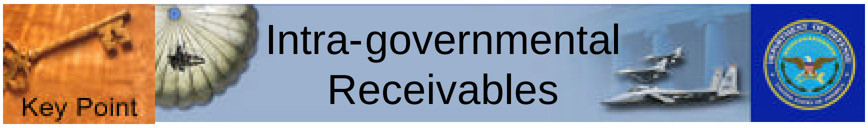
Performance metrics for the Department are based on government-wide metrics for the collection and reporting of Accounts Receivable. Notice that the government-wide metrics for delinquent public Accounts Receivable and Intra-governmental receivables that are greater than 180 days old can be no more than 10% of total receivables in each category.

The Department is looking for improvement in each performance metric, but especially in the 180 days delinquent receivables, in an effort to prepare for the audit of Accounts Receivable.

Let's look at intra-governmental receivables.



Intra-governmental Receivables

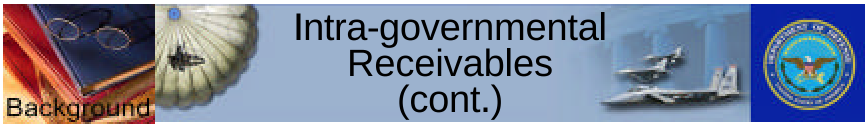
- **Customer identification**
- **Why elimination of intra-governmental receivables are important**
- **Problems with delinquent intra-governmental receivables**

The customer identification is a means to identify the categories of intra-governmental receivables. The identification of these receivables is important to the elimination process.

In Lesson 1, we defined intra-governmental transactions as transactions among federal entities. They result in claims of a federal entity against other federal entities or claims against the entity by other federal entities. They do not include transactions with state and local entities and non-appropriated fund activities, nor do they include Foreign Military Sales (FMS) transactions.

Intra-governmental transactions that result in an amount due to your entity are intra-governmental receivables.

Let's look at how customer identification allows for the identification of intra-governmental receivables by category.



Intra-governmental Receivables (cont.)

Trading partners are the buyers and sellers and are categorized at levels:

Level 1 – DoD to other federal government entities

Level 2 – Between DoD reporting entities

Level 3 – Within departmental reporting entity

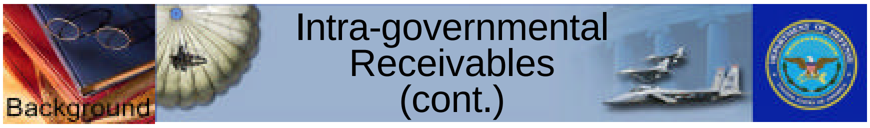
Customer identification allows for the identification of intra-governmental receivables by category. The identification of customers or trading partners is important because transactions between agencies of the federal government must be eliminated on the consolidated financial statements.

Let's assume that we have a Level 1 transaction. That is a transaction between an entity within DoD and another federal government entity such as the Department of Education. DoD records a sale and the Department of Education records a purchase. At what point are tax dollars being spent?

Actually, they are not since this transaction is wholly within the federal government. When the financial statements of the federal government are consolidated, this transaction must be eliminated or it will overstate the amount of resources used in the accomplishment of the government's mission.

This does not mean that the transaction is not recorded or reported. The transaction remains on the books of each federal entity and is dropped only at the consolidated level where all of the federal entities financial statements are combined.

Let's look at a few examples of intra-governmental transactions.



Intra-governmental Receivables (cont.)

Intra-government buy/sell examples:

- **Interfund purchases**
- **Government Purchase Card (purchases from federal sources)**
- **General Services Administration (GSA) supply card purchases**
- **GSA vehicle and space rental**
- **Transportation purchased from USTRANSCOM, including those billed directly from USTRANSCOM or via PowerTrack**
- **Supplies/services provided under MIPR accepted category I (reimbursable)**
- **Services provided under Inter/Intra-service Support Agreements**

Transfer examples:

- **Assets transferred between federal partners (with or without resources)**
- **Appropriation and non-expenditure transfers**

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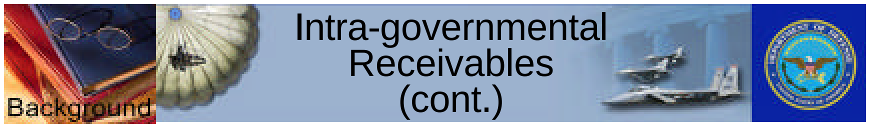
Here are a few examples of intra-governmental transactions that may result in intra-governmental receivables.

Using the example of reimbursable work such as the DD Form 448, MIPR, the amount of the order is recorded as an unfilled customer order by the ARO upon receipt of the accepted order. Once documents are received showing that goods or services were provided (and revenue was earned), a receivable is recorded at the detail transaction level and a bill is generated to submit to the customer. The unfilled customer order account is reduced and the filled customer order uncollected account is increased. If this reduction in the unfilled customer order account causes an abnormal balance, the ARO researches the cause of the imbalance.

Although amounts in the filled customer order uncollected account are aged, those involving intra-governmental receivables are not charged interest, penalties, or administrative fees. If systems permit, these transactions are collected through automated or regularly established self-collection methods such as the Military Standard Billing System (MILSBILLS), Treasury's Intra-Governmental Payment and Collection (IPAC) system, and intra-governmental charge card methods. When automated collection procedures cannot be used, the SF 1080, Voucher for Transfer between Appropriations and/or Funds, is used. Remittance by check from federal agencies is a last resort.

Let's look at recording collections.



Recording Collections on Intra-governmental Receivables

- **An allowance for doubtful accounts is not allowed for federal government entities**
- **The full settlement of intra-governmental Accounts Receivable shall take no longer than two years**
- **Adjustments or corrections are made after research**

In recording collections, an SF 1080, automated or manual, is processed through the Treasury registration process. The recording of the collection register within the accounting records liquidates the outstanding Accounts Receivable.

The ARO and the fund holder are responsible for managing intra-governmental receivables. Intra-governmental receivables cannot be reduced by means of an allowance for doubtful accounts. Additionally, intra-governmental receivables cannot be transferred to a receivable collection activity.

The full settlement of intra-governmental Accounts Receivable must not take longer than two years, and Accounts Receivable can be adjusted or corrected only after research has been accomplished and the intra-governmental Accounts Receivable is determined to be invalid.

Disputes between governmental agencies (outside the DoD) are forwarded to the performer's Component Comptroller or designee for review only after appropriate research and collection actions have been performed.

To facilitate the processing and reporting of intra-governmental transactions, agreements may be made between trading partners. Let's discuss these agreements.

Intra-governmental Receivables (cont.)

Trading Partnership Agreement

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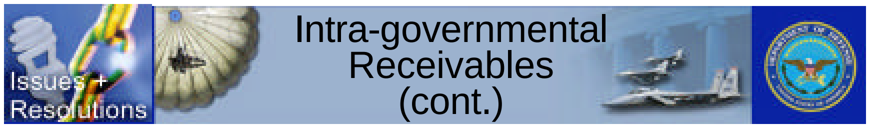
Trading partners make Trading Partnership Agreements (TPA) to address the problem of eliminations. A TPA is an agreement between trading partners to define what each expects to see on an actual transaction that is processed. For uniformity and consistency, a standard TPA has been developed to ensure that minimum data is included. The TPA can be expanded only with additional data as required by both parties and cannot be modified to delete standard data. TPAs can be bilateral or unilateral. The bilateral agreement is a two-way agreement. The unilateral agreement is an agreement with conditions focused in one direction.

The Interfund is a system used by trading partners to bill and collect for sales of Defense Working Capital Fund (DWCF) managed stock material supplied by different Military Departments, Defense Agencies, and the GSA. The Interfund system encompasses automated billing and fund transfer processes designed to immediately replenish the seller's cash reserve. The requisitioner (buyer) initiates the Interfund billing process by submitting a Military Standard Requisitioning and Issue Procedure (MILSTRIP) formatted requisition (DD Form 1348) which identifies desired materials and the appropriation providing the funding. The sellers' billing and collections are automatically generated by the financial system upon constructive issuance of MILSTRIP items. The sellers bills are immediately reimbursed for items issued from stock citing the buyers appropriated funds.

The two main causes for Interfund bill disconnects are capturing and matching the correct line of accounting, and the timeliness of reporting by both the buyer and seller organizations. Prompt identification, reconciliation, and resolution of these problems are key to the Interfund process. There has been considerable emphasis for better reconciliation of Interfund bills.

Let's examine an issue and planned resolution concerning intra-governmental transactions.



Intra-governmental Receivables (cont.)

Weaknesses

- **Vast majority of DoD accounting systems cannot identify the trading partners at the transaction level**

Solution

- **Intra-governmental Transaction System (IGTS) Program Management Office (PMO) in conjunction with the OUSD(C), OUSD Acquisition, Technology, and Logistics (AT&L), and representatives from Military Services and Defense Agencies are developing an end-to-end process model to address material weaknesses**
  - **— Updated policies and business rules**

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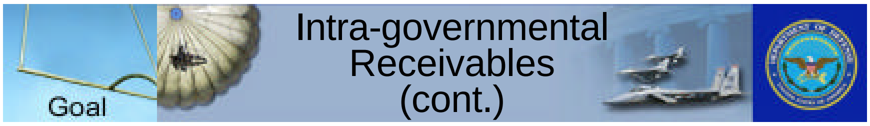
An identified weakness within the intra-governmental transaction process is that a vast majority of DoD accounting systems cannot identify the Trading Partners at the transaction level.

In an effort to solve this issue, the Intra-governmental Transaction System (IGTS) Program Management Office (PMO) in conjunction with the OUSD(C), OUSD Acquisition, Technology, and Logistics (AT&L), and representatives from Military Services and Defense Agencies are developing an end to end process model to address material weaknesses.

This end-to-end process development should result in updated policies and business rules.

Let's talk about the goal for the reconciliation of intra-governmental receivables.



Reconciliation Goal

No more than a 2 percent reconciliation amount difference from net intra-governmental receivables reported on the financial statements to those reported on the MRR.

The goal for intra-governmental Accounts Receivable reconciliation involves a comparison of Net Intra-governmental Receivables on the financial statements to the MRR. It requires that there be no more than a 2 percent reconciliation amount difference from net intra-governmental receivables reported on the financial statements to those reported on the MRR.

Let’s continue with the verification of receivables.

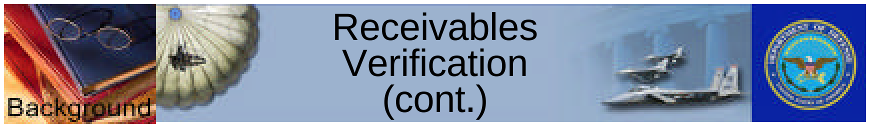
Verification Processes

- **Management assertions**
- **Aging reports**
- **Metrics**
- **Audit tools**
- **GAO/PCIE FAM**
- **Common procedures**

In previous topics you learned about the recognition of receivables and required receivables documents. You learned about debt collection and the valuation of receivables. In Receivables Reconciliation you learned about the duties and responsibilities for reconciliation and reporting requirements. Then in Intra-governmental Receivables you found that they are reported separately and are eliminated at the appropriate level of consolidation of the financial statements.

In Receivables Verification, we describe verification processes for receivables account balances using tools such as aging reports and metrics. We will discuss audit tools that are available to you such as the Government Accountability Office/President's Council on Integrity and Efficiency Financial Audit Manual (GAO/PCIE FAM), more commonly called the FAM. We will discuss the verification process from an audit perspective to increase your understanding of the audit requirements, then we will discuss some common procedures for account verification.

Let's begin with a look at management assertions.



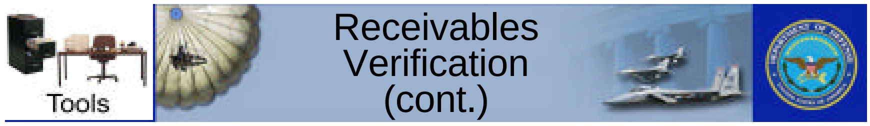
Receivables Verification (cont.)

Management Assertions

- **Existence or Occurrence**
- **Completeness**
- **Rights and Obligations**
- **Valuation or Allocation**
- **Presentation and Disclosure**

Verification processes for receivables are processes used to verify that the amounts reported as receivables are based on transactions that have occurred during the given period and that the receivables exist at a given date (Existence or Occurrence); that all valid receivables are recorded and properly classified (Completeness); that the entity has the right to the proceeds of the receivables as evidenced by legal title or similar signs of ownership (Rights and Obligations); that they are recorded at appropriate amounts and are valued based on an appropriate valuation method (Valuation or Allocation); and that they are properly classified and described in the financial statements, consistent from period to period, with footnotes that contain all information required to be disclosed (Presentation and Disclosure).

Let's discuss the tools available to you to verify these assertions in preparation for an audit of your Accounts Receivable.



Aging Reports

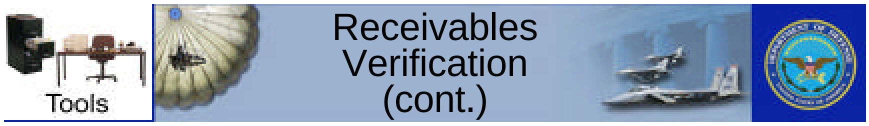
- **MRR shows receivables by category and age, and field sites reconcile the subsidiary ledgers to the General Ledger Trial Balance, the MRR data, and the TROR to ensure all reports balance**
- **MDMR is reconciled with the general ledger, the TROR, and the MOCAS DLTR on a monthly basis**
- **TROR informs federal decision makers of the gross book value of debts and actions taken to enforce collection**
- **Certification of verification**

Aging reports are used to verify the value and allocation of receivables. When amounts reported are not in agreement, you must investigate the reasons for the differences.

Timing differences may be explained by the receipt of documents, confirmations, or other manually prepared documentation within a reasonable time from the date of the reports. If documentary evidence is not received in a timely manner, then the differences may not be explained as timing differences.

Procedural differences must be resolved. For example, if there is a specific procedure for writing off a debt, then that procedure must be followed in order to keep the financial records in agreement with the aging reports. If there are differences due to a lack of procedural guidance, then that guidance must be made available. Manual processes may cause differences where no systems interfaces are available. These processes must be monitored from initial data entry at the time of the transaction to the eventual collection, write-off, or reporting of the debt. The Director of Accounting of each center certifies the completion of the verification process by November 15 of each year.

The FAM is one tool used by the auditor in the performance of the financial statement audit, which is also available to you. Let's examine a portion of the FAM that concerns Accounts Receivable.



Use of the GAO/PCIE Financial Audit Manual

Section III Balance Sheet

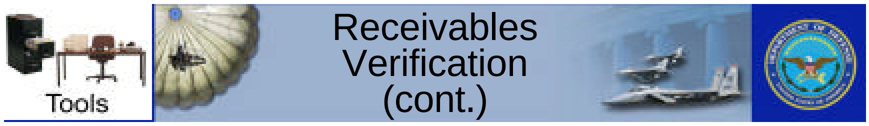
The questions related to the balance sheet are contained under 23 line items. The question numbers related to each line item follow.

Item	Line Item	Question Numbers
	Assets	
1.	Fund Balance with Treasury	5-22
…	…..	…
3.	Accounts Receivable (Net)	33-49
…	…	…
7.	Inventory and Related Property	103-125
8.	Operating Materials and Supplies	126-137
…	…	…
13.	General Property, Plant, and Equipment (Net)	187-233

GAO/PCIE FAM: http://www.gao.gov

Using the FAM, you may view checklists of questions that are designed to verify that the assertions made by management concerning the financial condition of your entity are based on factual data or reasonable estimates. The FAM is a two-volume manual. The first volume provides guidance concerning the audit process, while the second volume provides specific guidance concerning areas to be evaluated. Audit checklists are contained in the second volume.

Let’s examine some of the questions related to Accounts Receivable.



Use of the GAO/PCIE Financial Audit Manual (cont.)

Questions related to Accounts Receivable

Item	Question	Auditor Response
33	Is a receivable recognized when a federal entity establishes a claim based on legal provisions or when goods or services are provided? (SFFAS 1, par.41)	
34	If the exact amount of a receivable is unknown, is a reasonable estimate made? (SFFAS 1, par. 41).	
35	Are receivables from federal entities reported as intra-governmental receivables, and reported separately from receivables from nonfederal entities? (SFFAS 1, par. 42; OMB Bull. 01-09, P. 19, section 3.3)	
36	Are receivables not available to an entity disclosed in a note to the financial statements as nonentity assets, separate from receivables available to the entity? (SFFAS 1, par. 43; OMB Bulletin 01-09, p. 19, section 3.3 & p. 56, section 9.2)	
37	Are losses on receivables recognized when it is more likely than not (greater than a 50 percent chance of occurrence) that the receivables will not be totally collected? (SFFAS 1, par. 41)	
38	Is an allowance for estimated uncollectible amounts recognized to reduce the gross amount of receivables to their net realizable value, and is this allowance re-estimated on each annual financial reporting date and when information indicates that the latest estimate is no longer correct? (SFFAS 1, par. 45)	

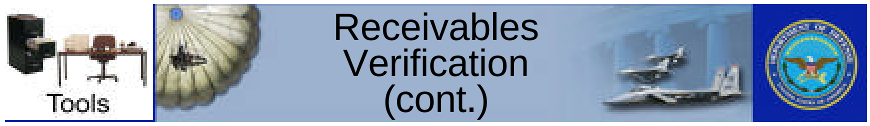
Notice that question 33 concerns the recognition of a receivable. To verify that receivables are recognized when goods or services are provided, you may examine your procedures for entering receivables and the applicable dates from which the transactions are aged. Notice that the question cites the related reference for the accounting standard being applied. If you or the auditor needs further clarification concerning the requirement, the reference cited can give additional information.

Although question 34 refers to a reasonable estimate, what is really being tested is also the timing of the entry of the receivable. You must determine if receivables are entered on a timely basis, even if they must be later adjusted when confirmation of amounts are received. These confirmations may be in the form of partial shipments, partial payments, or cost estimates.

Notice that question 35 concerns the separation of public and intra-governmental receivables. You must ensure that you have procedures in place to identify customers as federal and nonfederal in order to separately report these receivables.

Question 36 concerns collections made for others, and question 38 concerns the establishment of the allowance for bad debts. Some questions will not be applicable to your entity and may be skipped. Using this reference as a guide, you may set up checklists of applicable questions in an evaluation of your receivables processes.

Let's look at a few more questions.



Receivables Verification (cont.)

Use of the GAO/PCIE Financial Audit Manual (cont.)

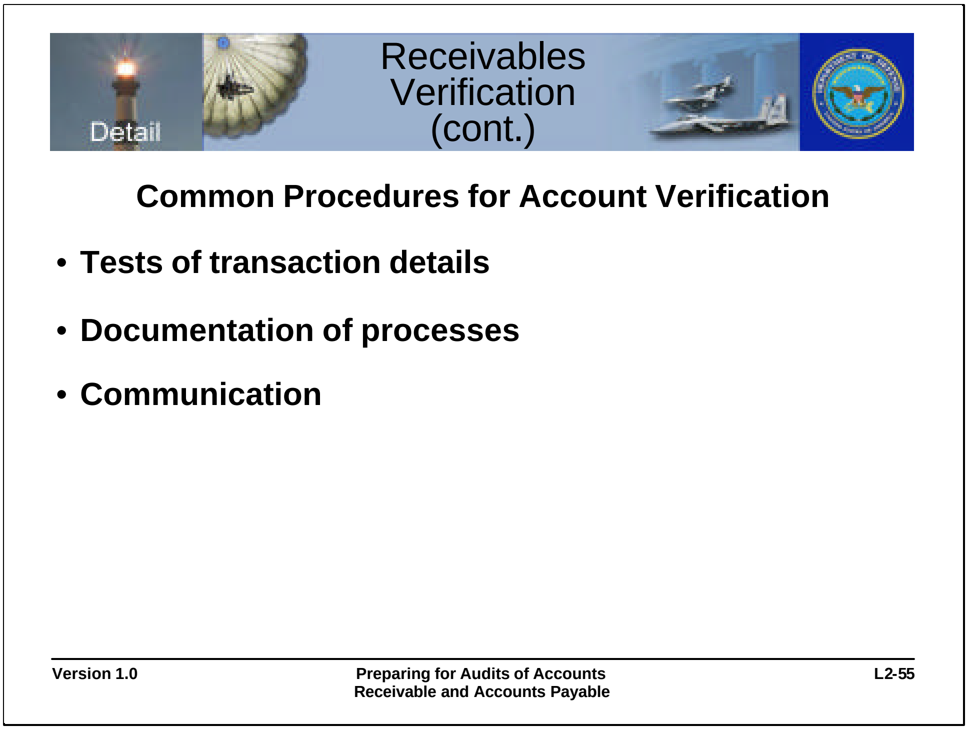
Item	Question	Auditor Response
39	Is an allowance for uncollectible amounts based on an analysis of both individual accounts receivable and groups of accounts receivable as prescribed by the standards? (SFFAS No. 1, par. 47-51; SFFAS 7, par. 56)	
40	Are accounts that represent significant amounts individually analyzed to determine the loss allowance? (SFFAS 1, par..47)	
41	Is the loss estimation for individual accounts based on the following? a. Debtor's ability to pay b. Debtor's payment record and willingness to pay c. Probable recovery of amounts from secondary sources including liens, garnishments, cross collections, and other applicable collection tools (SFFAS 1, par. 47)	
…	…	
44	Does the reporting entity disclose the following? a. The major categories of account receivables by amount and type b. The methodology used to estimate the allowance for uncollectible amounts c. The dollar amount of the allowance for uncollectible accounts (SFFAS 1, par. 52; OMB Bull. 01-09, p. 60, section 9.6)	

Questions 39 through 43 continue with the estimation of an allowance for uncollectible amounts.

Question 44 concerns the presentation format of the receivables and the disclosure of methods used for estimating uncollectible amounts.

Additional questions discuss non-exchange transactions, assessments, and the recognition of interentity receivables.

There are a couple of procedures that are common to the verification process. Let's talk about them.

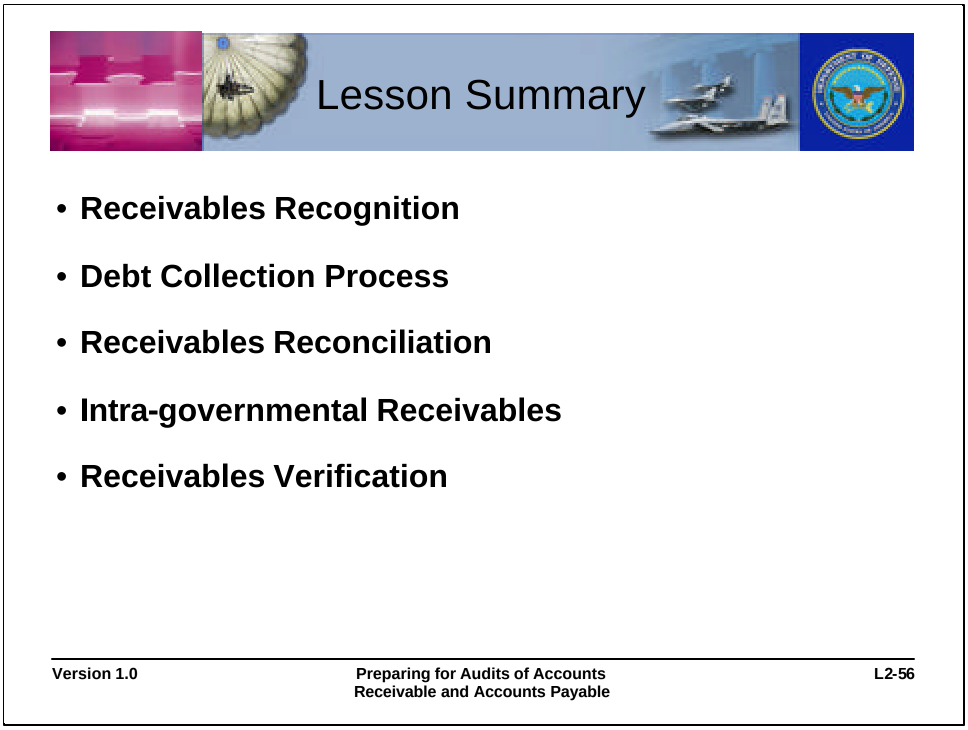


You should test the details of a sampling of transactions that are the basis for the amounts reported on the financial statements. To do this you must ensure that you can trace a transaction from the financial statements back to the originating entry. The auditors will test the details of transactions during the year for the dual purpose of familiarizing themselves with your internal control of the receivables process and evaluating whether the procedures you use are timely, accurate, complete, and in accordance with applicable guidance. At the end of the year, the auditor will perform cutoff tests to test the amounts reported on the financial statements against the transaction detail that supports those balances.

That sounds easier than it is. To test the details of a reported amount, you must understand how data is pulled from each source to be eventually reported on a single line of the Balance Sheet. A useful tool in this process is a Performance, Analysis, and Design (PAD). A PAD describes the process in common language and provides a graphic depiction of the systems, manual inputs, decision points, outputs, and file locations.

In addition to mapping processes, reconciling reports, and evaluating procedures, communication is a key tool in the verification of receivables. You must communicate with everyone involved in the process, from the customer, to the data entry technician, to the accounts analyst, and others.

Now let's summarize what we've learned in this lesson.



In this lesson, you learned that receivables are recognized at the time of the legal transfer of the associated asset title and that the date of recognition is important for several reasons to include the aging of the receivable. We discussed the sources of receivables transactions and document handling procedures to include file maintenance, internal control techniques, and SOPs.

In the discussion of debt collection processes, you explored the provisions of the DCIA and estimation of an Allowance for Uncollectible Accounts. We discussed the aging of receivables accounts and processes used for debt collection within the Department.

Receivables Reconciliation involves several individuals and offices, including the fund holder, ARO, DMO, and DCM. We discussed several reconciliation reports, including the MDMR, the MRR, and the TROR, and noted that the long term goal is for the DDRS audited financial statements, TROR, and MRR to be fully reconciled.

You found that customer identification allows for the identification of intra-governmental receivables by category, and that this categorization is key to the elimination of intra-governmental receivables required on consolidated financial statements. We discussed the recording of collections of intra-governmental receivables and that intra-governmental receivables cannot be reduced by means of an allowance for doubtful accounts.

In Receivables Verification we discussed tools such as aging reports and audit tools that are available to you such as the FAM. We also discussed some common procedures for account verification to include tests of transaction details, documentation of processes, and communication.

The following slide lists references available for additional information.

References

SFFAS No. 1: http://www.fasab.gov/pdffiles/sffas-1.pdf

NARA GRS: http:www.archives.gov/records-mgmt/ardor

DCIA:
http://www.fms.treas.gov/news/factsheets/dcia.html

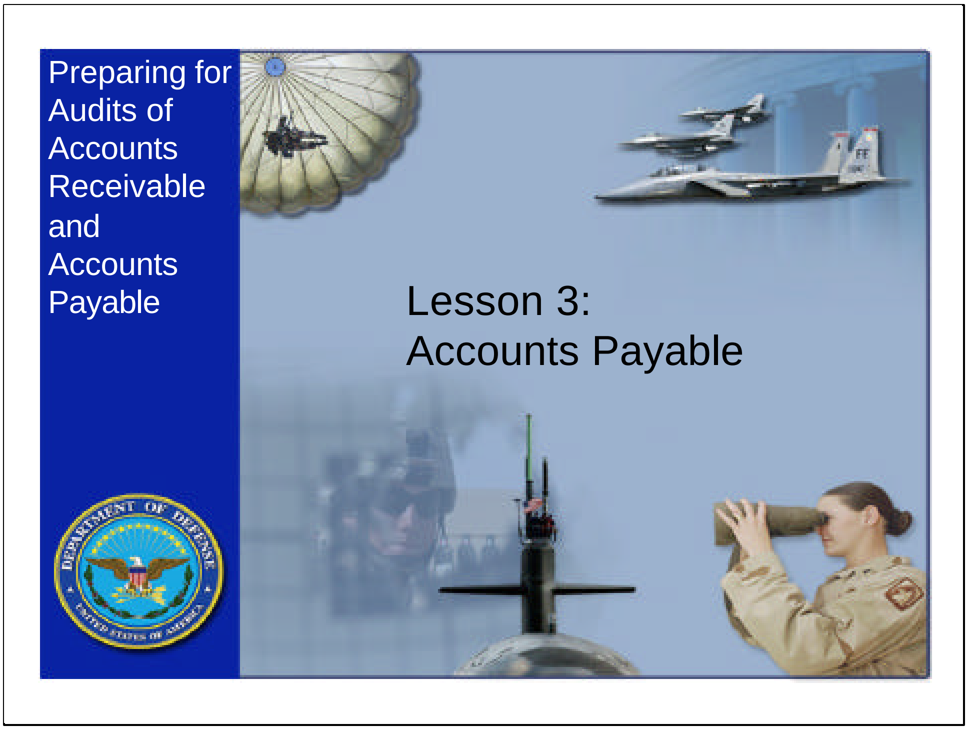
CONOPS for Managing Accounts Receivable:
https://dfas4dod.dfas.mil (DFAS only)

TROR: http://www.fms.treas.gov/debt/dmrpts.html

GAO/PCIE FAM:
http://www.gao.gov/special.pubs/01765G

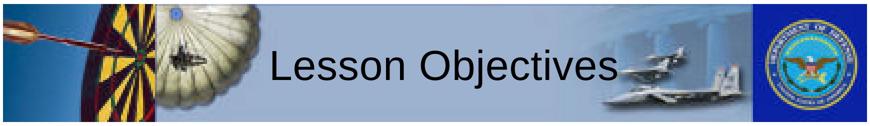
Questions

Before we move to Lesson 3, Accounts Payable, do you have any questions on the material covered in this lesson?



In Lesson 3, we explore information on how purchases comprise a majority of the financial transactions of the Department of Defense (DoD). These purchases are the source of the Accounts Payable reported on the financial statements. More importantly, these purchase transactions, whether for goods or services, are the foundation of the Department's ability to operate.

Let's discuss the lesson objectives.



Upon successful completion of this lesson, you will be able to:

- **Identify payable transactions**
- **Associate budgetary resources and payable authorizations**
- **Reconcile payable balances**
- **Explain intra-governmental eliminations of payable balances**
- **Discuss audit processes as they relate to payable balances and accompanying notes**

The main focus of this lesson will be on the proper authorization, recording, payment, and reporting of payable transactions both public and intra-governmental.

First, we will identify payable transactions, budgetary resources, and payable authorizations. And then discuss payable balances, intra-governmental eliminations, and audit processes that relate to these balances and accompanying notes.

Let's look at the lesson topics.

Lesson Topics

This lesson contains the following topics:

- **Payables Recognition**
- **Budgetary Resources and Payable Authorizations**
- **Payables Reconciliation**
- **Intra-governmental Eliminations of Payable Balances**
- **Payables Verification**

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In recognizing payables, we describe the sources of payable transactions and discuss document handling procedures. We will also discuss the provisions of the Prompt Payment Act. In discussing Budgetary Resources and Payable Authorizations, we talk about funds authorization and the provisions of the Anti-Deficiency Act (ADA).

As we move on to Payable Reconciliation, we discuss the benefits of reconciliation and describe the reconciliation process. In Intra-governmental Eliminations of Payable Balances we reiterate the need for eliminations on consolidated financial statements and discuss the particular processes that are used when there are disputes over intra-governmental payable and delinquent payments.

We will describe the payables verification process and some of the tools available. You will gain an understanding of the auditor's processes as they relate to verification of your payable and be able to utilize the same processes.

Let's begin with the recognition of payables.

Payables Recognition

What are the sources of payable transactions and how are payable documents handled?

- **Sources of transactions**
- **Document handling procedures**
- **Prompt Payment Act**

Authoritative Guidance

SFFAS No. 1: http://www.fasab.gov/pdffiles/sffas-1.pdf

SFFAS No. 5: http://www.fasab.gov/pdffiles/sffas-5.pdf

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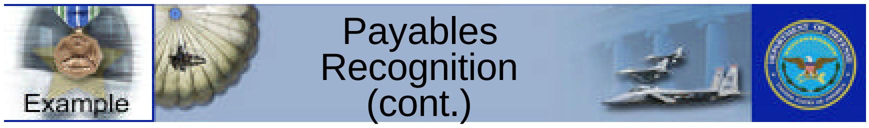
Sources of payable transactions include goods and services received from, progress in contract performance made by, and rents due to federal and non-federal entities. Document handling procedures are used to formally record the payable transactions into the financial statements. We also discuss the provisions of the Prompt Payment Act, including the provision for the payment of interest penalties. This act provides vital information to the payment of interest penalties.

Authoritative guidance are contained in the Statements of Federal Financial Accounting Standards (SFFAS) Nos. 1 and 5. SFFAS No. 1, Accounting for Selected Assets and Liabilities, defines Accounts Payable, and describes payables recognition. SFFAS No. 5, Accounting for Liabilities of the Federal Government, also addresses payables and when to recognize the payable for services.

Let’s explore the sources of payable transactions.



Payables Recognition (cont.)

Sources of Transactions

Payables transactions are supported by:

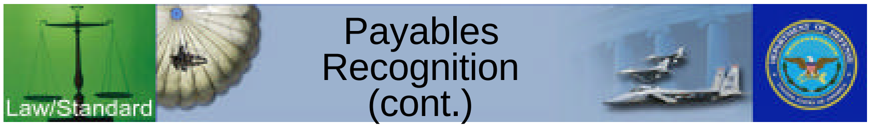
- **Requisition documents**
- **Contracts, vendor invoices (entitlement systems), receiving reports**
- **Construction progress reports, performance based service contracts**
- **Fees, rental agreements, leases, freight charges**
- **Contract modifications**

Several types of documents may provide the source of an Accounts Payable transaction. These documents evidence the delivery of goods or services requested by your entity. That request may take the form of a requisition document such as a blanket purchase agreement, delivery order, purchase order, contract, rental agreement, lease, or contract modification.

Evidence of delivery may be in the form of a receiving report such as a Department of Defense (DD) Form 250, Material Inspection and Receiving Report, or a certificate of performance on an invoice, delivery ticket, voucher, or other vendor-generated form.

Once evidence of a valid transaction such as a properly authorized order accompanied by a proper receiving report evidencing delivery is obtained, the payable is entered into the accounting system to await payment at the appropriate time.

Let's discuss the recognition of these transactions.



Payables Recognition (cont.)

SFFAS, No. 1, Paragraph 77, Accounts Payable

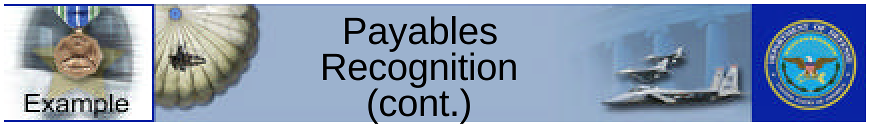
When an entity accepts title to goods, whether the goods are delivered or in transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated.

Accounts Payable do not include liabilities related to ongoing continuous expenses, such as salaries and benefits; those are “other liabilities” on the Balance Sheet.

According to SFFAS No 1, paragraph 77, when an entity accepts title to goods, whether the goods are delivered or in transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated. Notice that we are talking about goods or services that are provided by a vendor or another entity. Accounts Payable do not include liabilities related to ongoing continuous expenses such as salaries and benefits.

Recognition is defined as the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like. The recognition process begins with the receipt of a document or documents that provide evidence of the completion of an act that requires the Department to pay amounts owed at some future date. According to the Federal Accounting Standards Advisory Board (FASAB), the effective date of the recognition is based on the date of transfer of ownership of the goods, even if they are still in transit.

Let’s look at an example.



Payables Recognition (cont.)

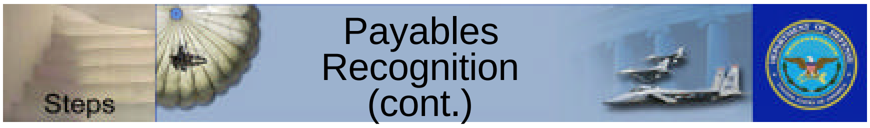
Example of Recognition

When a contractor provides the government with goods that are also suitable for sale to others, the liability usually arises when the contractor physically delivers the goods and the government receives them and takes formal title. However, when a contractor builds or manufactures facilities or equipment to the government's specifications, formal acceptance of the products by the government is not the determining factor for accounting recognition. Constructive or de facto receipt occurs in each accounting period.

For clarification, the FASAB provided the example that when a contractor provides the government with goods that are also suitable for sale to others, the liability usually arises when the contractor physically delivers the goods and the government receives them and takes formal title. However, when a contractor builds or manufactures facilities or equipment to the government's specifications, formal acceptance of the products by the government is not the determining factor for accounting recognition. Constructive or de facto receipt occurs in each accounting period.

For facilities or equipment constructed or manufactured by contractors or grantees according to agreements or contract specifications, amounts recorded as payable should be based on an estimate of work completed under the contract or the agreement. The estimate of such amounts should be based primarily on the federal entity's engineering and management evaluation of actual performance progress and incurred costs.

Now let's talk about document handling procedures.



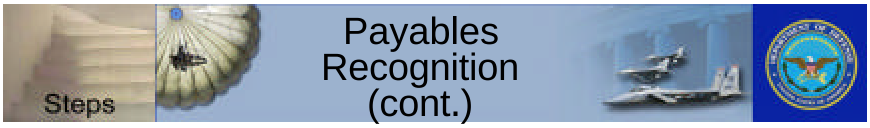
Payables Recognition (cont.)

Document Handling Procedures

- **Internal control techniques**
- **Purchase and accounting processes**
- **File maintenance**
- **Standard Operating Procedures (SOPs)**

Document handling procedures involve internal control techniques, processing of payable transactions, the location and format in which files must be maintained, and the requirement for those techniques to be a part of the Standard Operating Procedures (SOPs) of your entity.

Let’s look at internal control procedures for the processing of Accounts Payable.



Payables Recognition (cont.)

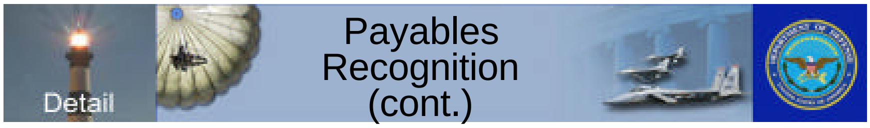
Internal Control Techniques

- **Separation of duties**
- **Accountability, authorization, and approval**

In talking about internal control for Accounts Payable transactions, entities must identify controls that ensure that goods and services are received, recorded, reported, reconciled to the financial statements, and payments are properly processed.

For the recognition of payables, these controls fall into two categories, the separation of duties; and accountability, authorization, and approval.

Let’s look at the separation of duties first.



Separation of Duties

- **Have different people**
  - **Approve purchases**
  - **Receive ordered materials**
  - **Approve vouchers for payment**
  - **Review and reconcile financial records**
- **Potential consequences**
  - **Erroneous or fraudulent invoices approved for payment**
  - **Unauthorized payments made to non-existent vendors**

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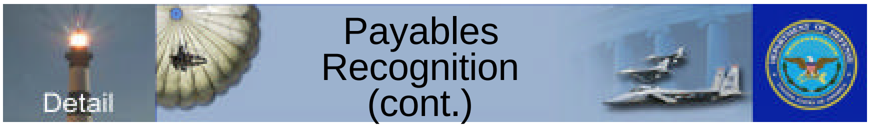
Separation of duties involves the separation of the approval for a purchase from the receiving of that purchase. It also involves the separation of duties in approving vouchers for payment and reconciling the financial records.

According to the Department of Defense Financial Management Regulation (DoDFMR), Volume 10, Chapter 1, managers with responsibilities for determining entitlement and authorizing and executing payments and collections are required to create, document, and maintain an organizational structure that appropriately segregates assigned duties, emphasizes adherence to policies and procedures, and employs sound internal accounting and systems access controls.

The potential consequences of not separating the duties involved in Accounts Payable may cause erroneous or fraudulent invoices approved for payment, and unauthorized payments made to non-existent vendors.

Now let's look at accountability, authorization, and approval controls.



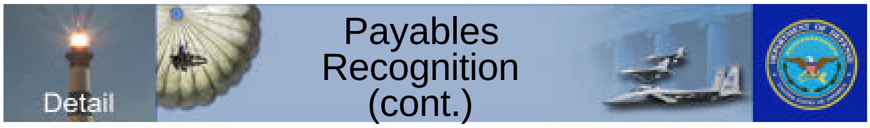
Payables Recognition (cont.)

Accountability ensures that you authorize, review, and approve invoices for payment based on signed agreements, contract terms, and purchase orders.

- **Review and update signature authorizations periodically**
- **Verify receipt of goods and services to contract/ purchase order and invoice information**
- **Reconcile ledgers for accuracy of recorded transactions**
- **Monitor that invoices are paid in a timely manner**

Accountability ensures that you authorize, review, and approve invoices for payment based on signed agreements, contract terms, and purchase orders. Accountability, authorization, and approval controls involve the review and update of signature authorizations on a periodic basis; the verification of receipt of goods and services to the contract or purchase order and invoice information; the reconciliation of ledgers for accuracy of recorded transactions; and the monitoring of invoice payment dates to ensure that they are paid in a timely manner.

Let’s discuss the potential consequences of failure to follow these internal controls.



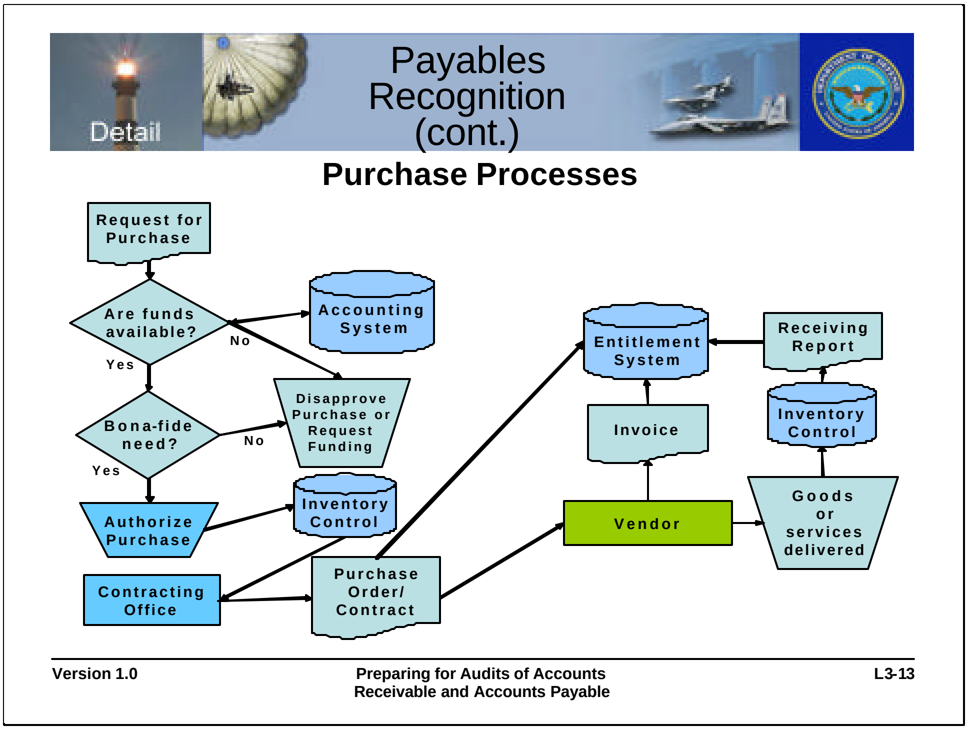
Potential Consequences

- **Unauthorized, unnecessary, or fraudulent payments or purchases**
- **Unauthorized work performed by vendors**
- **Loss of supplier discounts due to late payments**
- **Improper charges to accounts/funds**
- **Charges to incorrect accounts/funds**

The potential consequences of failure to update signature authorizations, verify receipt of goods and services, reconcile ledgers for accuracy, and monitor that invoices are paid in a timely manner are:

- unauthorized, unnecessary, or fraudulent payments or purchases
- unauthorized work performed by vendors
- loss of supplier discounts or imposed interest penalties due to late payments
- improper charges to accounts/funds
- charges to incorrect accounts/funds.

Now that you have seen some of the internal control and the consequences, let's examine the Accounts Payable process.

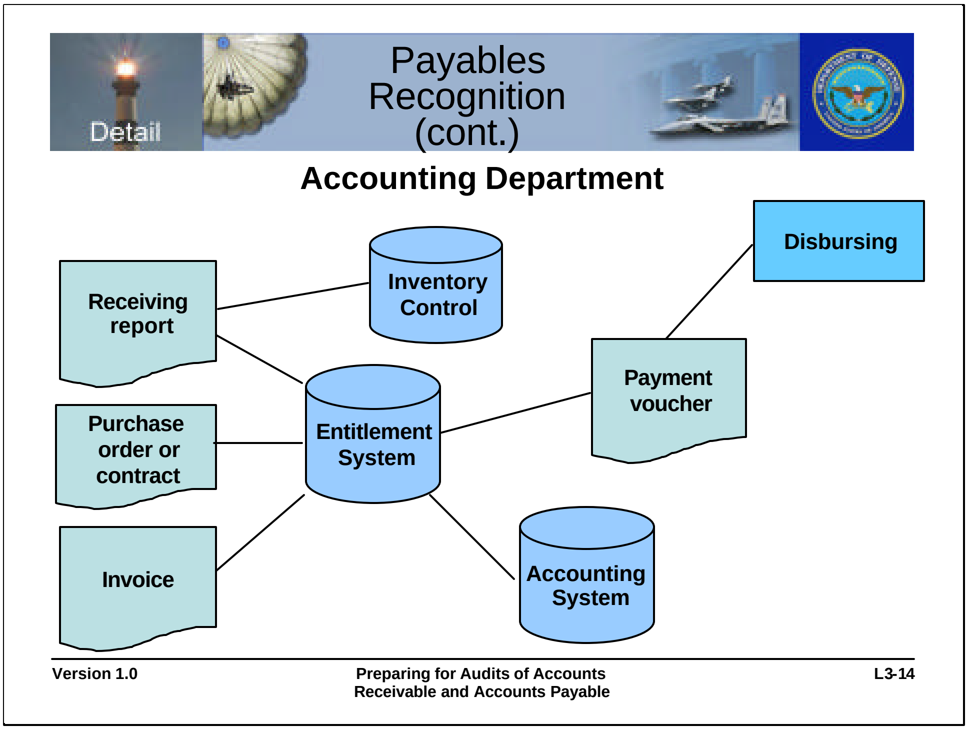


The purchase process begins with a request for purchase forwarded to an approving authority. The approving authority must ensure that funds are available in the accounting system and that the purchase fulfills a bona-fide need. If the need is bona-fide, but funds are not available, a distribution of funds may be requested to fill the need. If funds cannot be made available, the purchase should be disapproved pending availability of funds.

Once the purchase is approved, it is checked against normally stocked items that may be available through classes of supply. If the item requested is not available in inventory, and can not be purchased over-the-counter, a contract, blanket purchase agreement, or other purchase instrument is drawn up by a contracting official. Once terms are agreed and the contract is signed, a copy is forwarded for entry into the entitlement system, and the vendor performs in accordance with the terms of the agreement.

Vendor performance begins the payables cycle. Upon completion of the service or delivery of goods, the vendor submits an invoice describing the goods or service provided, the amount, the date, and the vendor's name to the appropriate contract or vendor pay office (entitlement system). It is when the goods or services are provided that the payable is recognized whether or not the receiving report, invoice, or contract has been appropriately entered into the entitlement system.

Upon receipt of the goods or service, the inventory control system is updated at the DoD Component, and the receiving and acceptance documentation is forwarded to the entitlement office. There is no system interface in the receiving-to-entitlement process. This causes several problems to include delayed payment, non-receipt of receiving documents, and loss of continuity of processes. Let's look at the entitlement system.

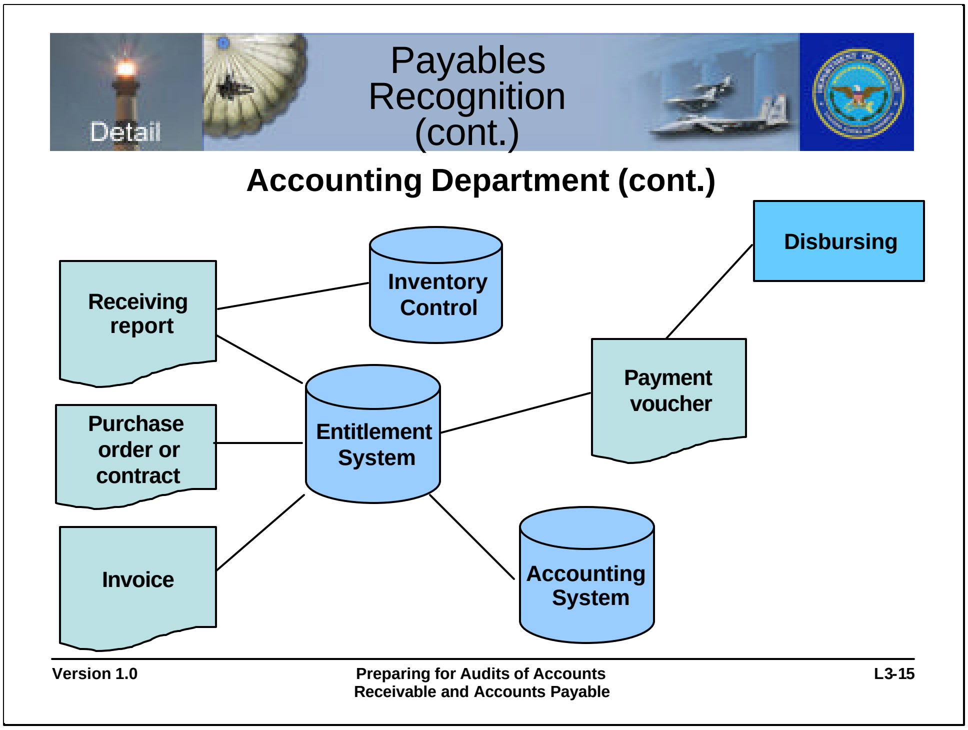


In the entitlement system, for most payments, the minimum required supporting documents are the contract, receiving report, and invoice. The contract or vendor pay office (entitlement system) reviews these documents for the required information. Communication is made with the accounting system to ensure funds availability and to set-aside the required funding for the payment. A payment voucher is completed (and certified) and is forwarded to the disbursing office for payment. There is also a disconnect between the entitlement systems and the accounting systems causing processing delays while research is made into funds availability for the required transaction payment.

In reviewing the purchase order or contract, the Contract or Vendor Pay Office looks for an original copy with the date and authorized contracting officer's signature and contact information, correct identification of the paying office and delivery address, delivery terms, valid line of accounting, and payment terms. They also look for vendor payment information. Vendor information is matched against a computerized vendor list that contains information for the payment of invoices through Electronic Funds Transfer (EFT). If the contract has been modified, any modifications are also reviewed.

When the invoice is received, it is reviewed for the name and address of the vendor, an invoice number and date, a reference to the contract or purchase order, description of goods or services delivered with extended price information, terms, and payment information. This information is compared to the purchase order or contract information.

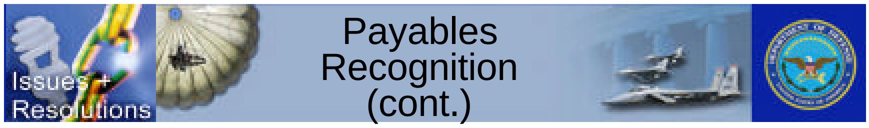
Let's continue our discussion of the entitlement system.



The receiving report is reviewed for reference to the purchase order or contract number, description and quantity of the goods received, accepted, or rejected, receipt and acceptance dates, and receiving and/or accepting official signature and contact information. If certified invoices are used in lieu of a separate receiving report, the invoices must contain the information applicable to the receiving report. If only the receipt of the goods or services is received, documentation of acceptance is still required prior to payment even though the account payable is established upon receipt.

Notice that there is no established communication link between inventory control (various logistics systems at the Component level) and the entitlement system. Delays in the receipt of receiving and acceptance reports give rise to the improper recording of Accounts Payable as the payables may be entered into the incorrect accounting period. Once documents are reviewed, a due date is established.

Let's examine some issues and resolutions that affect the recognition of Accounts Payable transactions.



Payables Recognition (cont.)

Accounts Payable reported on the Standard General Ledger for the DoD do not accurately reflect the liabilities associated with the actual receipt of goods and services.

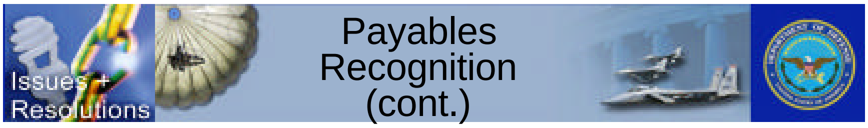
- **Receipt of goods and services are not reported timely by customers**
- **Weak internal controls**
  - **Inability to identify all Accounts Payable**
  - **Inability to analyze and age Accounts Payable**

Accounts Payable reported on the standard general ledger for the DoD do not accurately reflect the liabilities associated with the actual receipt of goods and services. The inability to consistently apply the accrual accounting concept results from a lack of integrated receiving and acceptance system from logistics to accounting. The inefficient communications between logistics and accounting is related to the incompatibility of legacy systems and untimely manual processes. As a result, expenses and liabilities are not recognized in the appropriate accounting period.

Examples of the disconnect between systems also affects systems between Components such as the Integrated Accounts Payable System (IAPS) not interfacing with the Computerized Accounts Payable System (CAPS) or the Standard Accounting and Reporting System (STARS) OnePay.

Further obstacles to good management of Accounts Payable are the inability to age payable amounts, the lack of reconciliation processes to the subsidiary accounts, and an inability to support the amounts reported in the financial statements.

Let’s discuss the actions of the affected entities to resolve this issue.



Payables Recognition (cont.)

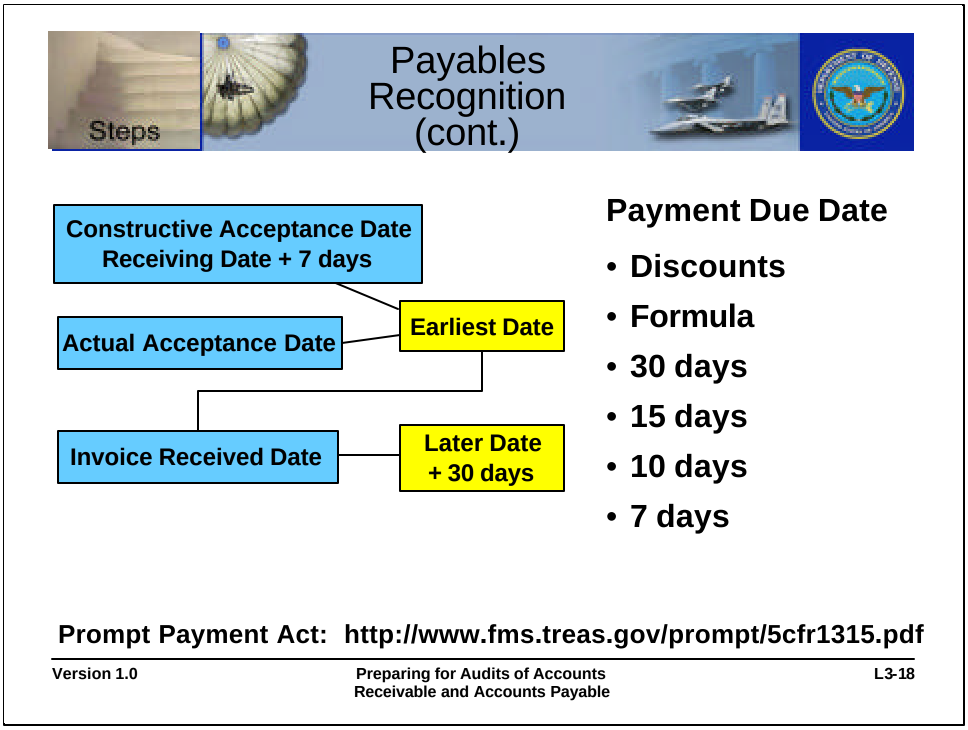
Department implemented efforts to correct Accounts Payable weaknesses:

- **Review of current business practices**
- **Establishment of a plan of action**
- **Implement metrics to measure the magnitude of the problem and the impact of corrective actions**
- **Validate that the identified weaknesses are corrected**

According to the 2004 DoD Performance and Accountability Report (PAR), the Department implemented efforts to correct Accounts Payable weaknesses with a review of their current business practices, the establishment of a plan of action, the implementation of metrics to measure the magnitude of the problem and the impact of corrective actions. They also plan to validate that the identified weaknesses are corrected.

In a Defense Finance and Accounting Service (DFAS) Strategic Targets Operating Plan, April 18, 2005, DFAS noted that they have established a joint client, accounting, and audit work-in-process team to define the problem criteria for Accounts Payable. They developed a plan of action and milestones to address the problems, and have set a goal that all public and intra-governmental Accounts Payable are identified, supported, recorded, and reconciled to the financial statements.

Now let's consider document handling procedures in the payables process.



Vendors sometimes offer discounts to obtain early payment of their invoices. For example, 2/10 means that the government is offered a two percent discount if the invoice is paid within ten days from the date of the invoice. Discounts are taken if they are advantageous to the government and the payment can be made within the discount period. Discount terms may be stated on the contract, the invoice, or both. If the terms are not in agreement, the government will take the most advantageous terms offered.

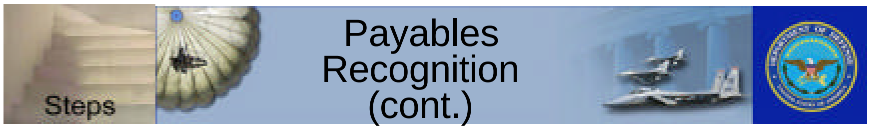
If the discount is not offered or taken, then a payment due date is calculated (usually by the vendor pay system) based on the provisions of the Prompt Payment Act as codified in the 5 Code of Federal Regulations (CFR) 1315 (subsections 1315.4 through .14). Due dates are determined as the later of the invoice receipt date and the date of constructive or actual acceptance of the goods or services plus 30 days for contracts that do not meet the Fast Pay criteria.

Fast Pay contracts are paid no later than 15 days after the receipt of the vendor's invoice. Agriculture products are paid no later than 10 days from the delivery date of the product, and meat and eggs are paid no later than 7 calendar days from date of delivery of the product. Dairy products are paid 10 calendar days from the invoice receipt date, and mixed invoices are either split or paid at the earliest due date.

Construction progress payments are made 14 days after the receipt of the request if longer terms are not specified to afford the government adequate time to assess performance. Final payment, based on completion and acceptance of all work, is made after the later of the 30th day after the date of invoice receipt or agency acceptance. Constructive acceptance occurs on the seventh day after the work or services have been completed in accordance with the terms of the contract.

Even though some contracts require payment prior to the actual receipt of receiving documents, the payment files are not closed until a receiving and acceptance report assures that the goods have been received and accepted. Upon payment of the invoice due, the Accounts Payable cycle is completed.

Let's consider file maintenance.



File Maintenance

- **Retention period**
  - **National Archives and Records Administration (NARA) General Records Schedule (GRS)**
  - **Office of the Under Secretary of Defense, Comptroller (OUSD(C)) Memorandum of October 20, 2003, requires documentation for one year after appropriation cancels**
- **Location**

NARA: http://www.archives.gov

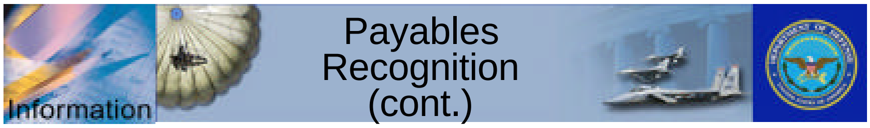
File retention and location are key to your ability to substantiate that the amounts reported on your Accounts Payable, and your payables process are in accordance with federal financial accounting standards. You must be able to access these documents and provide them to the audit staff when requested.

You must also be able to access historical payment records during the review and reconciliation processes.

In the last lesson we discussed the requirement for financial transactions to be maintained for at least the minimum period specified in the applicable National Archives and Records Administration (NARA) General Records Schedule (GRS) and longer if compelling reasons exist or supplemental guidance directs.

Supplemental guidance may be in the form of memoranda such as the Office of the Under Secretary of Defense, Comptroller (OUSD(C)) Memorandum, dated October 20, 2003, which requires documentation to be maintained for one year after the appropriation cancels.

Let’s look at some specific retention periods and locations for payable records.



Payables Recognition (cont.)

File Retention

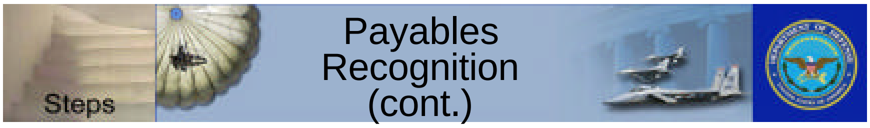
Schedule 7220, Vendor Pay Operations – Financial Records

Rule	Record Series	Description	Maintained In	Cut off/Disposition/ Authority
1.	Fund Distribution	Memoranda, Advice from the Accounting Operations Division for fund distribution records.	Any DFAS Vendor Pay Operations Office	Cut off at end of fiscal year. Destroy 6 years, 3 months after cut off. AUTH: (GRS 6, Item 1a) (7220/R1)
4.	Obligations	Documentation supporting undelivered orders outstanding (UOO) and accrued expenditures unpaid (AEU) pertaining to current, expired, and closed appropriations.	Any DFAS Vendor Pay Operations Office	Cut off at end of fiscal year. Destroy 6 years, 3 months after FY in which entitlement/ liability occurred. AUTH: (GRS 7, Item 3) (7220/R4)
5.	Expenditures	Original records supporting accrued expenditures paid (AEP) pertaining to current, expired, and closed appropriations.	Any DFAS Vendor Pay Operations Office	Cut off at end of fiscal year in which discrepancies identified by servicing sites have been corrected, if necessary, and final payment made. Destroy 6 years, 3 months after cut off. AUTH: (GRS 6, Item 1a) (7220/R5)

In the file series or Schedule 7220, Vendor Pay Operations – Financial Records of the DFAS 5015.2-M, Records Disposition Schedule, the first listing in the schedule is Fund Distribution. It includes memoranda and advice for fund distribution records. Notice that the files are maintained in the Vendor Pay Operations Office. Also notice that the destruction dates accorded to these records are six years and three months after the fiscal year in which the last action on the applicable records takes place.

Obligations include documents supporting Undelivered Orders Outstanding (UOO) and Accrued Expenditures Unpaid (AEU), while expenditures include records supporting Accrued Expenditures Paid (AEP).

Now let's look at the requirement for maintaining your SOPs.



Standard Operating Procedures (SOPs)

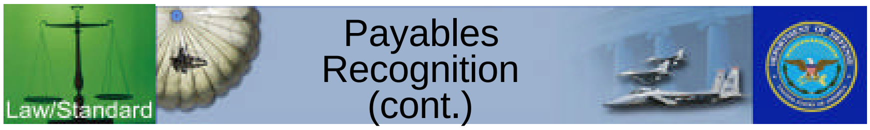
- **First-line user**
- **Includes controls, responsibility, and authority**
- **Sources of current guidance**

In the previous lesson you learned that an SOP is written for the first-line user and includes instruction on specific procedures for processing transactions and other procedures used within the applicable section. You also learned that it should include internal control and identify responsibilities and authority.

For the Accounts Payable process, current guidance for the update of your SOPs may be contained in SFFAS Nos. 1 and 5 (the most authoritative guidance), the DoDFMR, applicable laws such as the Prompt Payment Act and the ADA, system operating procedures such as the DFAS Vendor Pay Product Line CAPS Operations SOP, and file maintenance instructions. You may also use available guidance on internal control from various sources to include those outside of your organization. Training manuals and lessons learned are good sources of procedural information, and audit and inspection reports are sources for areas that may need to be addressed.

In gaining an understanding of your operations, the auditor will use your SOP. You must ensure that your personnel are familiar with its provisions and that it is up to date.

Now let's discuss the provisions of the Prompt Payment Act.



Prompt Payment Act

- **Requires federal entities to make payments in a timely manner**
- **Late payment requires interest (no contractor request is required)**
- **Applies to public, state, local, and foreign contractors**
- **Does not apply to federal entities, foreign governments, and contracts controlled by established foreign tariffs or agreements**

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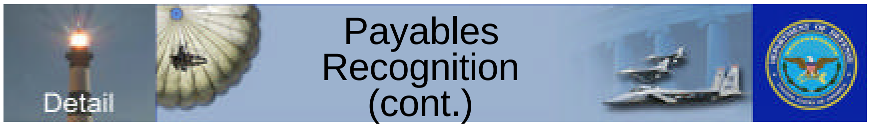
The Prompt Payment Act requires federal entities to make payments in a timely manner and requires the payment of interest if payments are late. If interest is not paid appropriately, additional interest penalties may apply.

The provisions of the Prompt Payment Act apply to payments to public, state, local, and foreign contractors. It does not apply to payments to federal entities, foreign governments, and contracts controlled by established foreign tariffs or agreements.

Let's look at the interest penalty requirements.



Interest Penalty Requirements

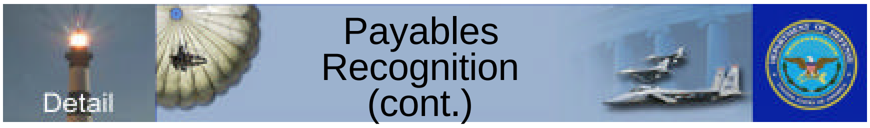
- **Will the payment be made after the due date?**
- **Will the interest due be greater than $1?**
- **Is an additional interest penalty due?**

Whenever an interest penalty is paid, the amount of interest paid and the calculation of that amount is furnished to the contractor with the respective payment. Interest payments of less than $1 on a single bill should not be made even if the total interest applicable to multiple bills exceeds $1. Interest is paid from the funds available for the administration of the program for which interest was incurred.

The rate of interest is the rate published semiannually in the Federal Register and in effect on the day after the due date (not necessarily the payment date). The specific interest rate is applied to the total penalty period (maximum 1 year interest) regardless of whether the interest period carries over into different interest periods. Interest penalties remaining unpaid for a 30-day period must be added to the principal amount owed to the contractor, and additional interest penalties are computed on the total debt including accrued interest.

An additional interest penalty is applied if the contractor is owed interest and (1) the interest was not paid with the invoice payment or within 10 days of that payment, and (2) the contractor makes a written request, no later than 40 days after the date on which the payment was made.

Let’s discuss reporting requirements for discounts not taken.



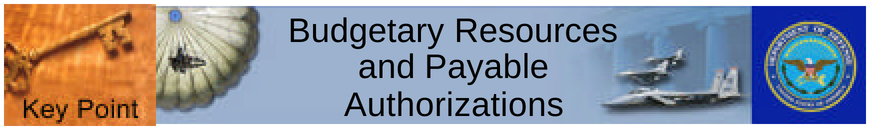
Reporting Requirements

- **Discounts not taken**
- **Late payments of commercial invoices**

Payment offices have the responsibility to maintain management information on lost discounts, including the reasons for their loss such as delays in obtaining an invoice, or the receiving documents not being available. This reporting includes the number and dollar value of discounts offered, cost-effective discounts lost, cost-effective discounts unavailable due to late documentation, and discounts that were not cost-effective and refused.

Performance information concerning late payments of commercial invoices is summarized in the 2004 DoD PAR (Page 14). An example of the Department's annual report is in Appendix B. This indicator highlights the degree to which the Department is able to reduce untimely commercial payments. Improvement in this area reduces cost to the Department and improves your relationship with your suppliers.

Let's move on to the next topic, Budgetary Resources and Payable Authorizations, to discuss the sources of budgetary funds.



Budgetary Resources and Payable Authorizations

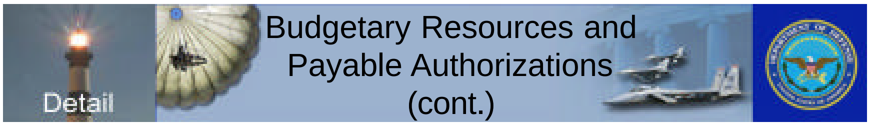
- **Sources of budgetary funds**
- **Funds authorization**
- **Anti-Deficiency Act**

Budgetary funds are received from Congress or through reimbursable activity and distributed by systems, such as the Program Budget Accounting System (PBAS) and the Automated Funds Management (AFM) system.

Authority for the use of this funding is received through Funding Authorization Documents (FADs).

The proper authorization and use of available funding is essential for the prevention of ADA violations.

Let's begin with a look at the sources of budgetary funds.



Budgetary Resources and Payable Authorizations (cont.)

Sources of Budgetary Funds

Program Budget Accounting System (PBAS):

- **Used to distribute Treasury Index (TI) 97, 21, and 17 funds**
- **Produces funds distribution documents and supports reporting**

Automated Funds Management (AFM) System:

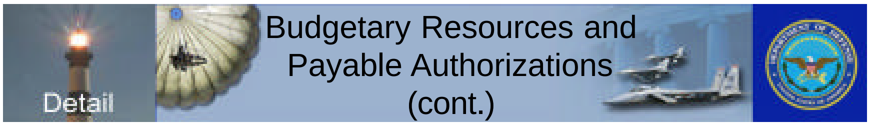
- **Used to distribute TI 57 funds**

Upon receipt of goods or services, a payable exists and must be recorded. It is possible that payables are unfunded upon their occurrence or that obligations have not been entered prior to the occurrence of a payables transaction. This does not mean that funding cannot be made available or that the obligation can not occur simultaneously with the recording of the payable transaction. If funds are available for transfer, appropriated funds managers may affect the transfer of funds through systems such as PBAS.

PBAS is used to distribute appropriated funds for use by the Secretary of Defense (SecDEF) and Directors of the Defense Agencies or activities (Treasury Index (TI) 97); the Secretary of the Army (TI 21); and the Secretary of the Navy (TI 17). Air Force (TI 57) funding is distributed by the Automated Funds Management (AFM) system.

Appropriated funds managers record control values within PBAS from the appropriation and authorization acts, OMB apportionments, and U.S. Treasury warrants and appropriation transfers. PBAS produces funds distribution documents that document funding issued as well as numerous reports of funds received, reprogrammed, and issued.

Let's look at an example of a funds distribution document.



Budgetary Resources and Payable Authorizations (cont.)

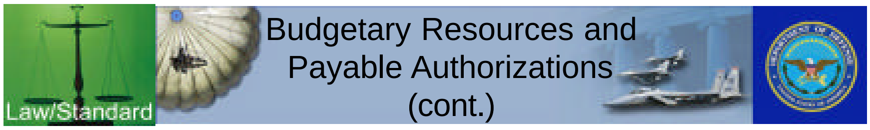
APPROPRIATION: 9797 2002/2003 0130.1833 DEF HEALTH PGM	FUNDING AUTHORIZATION DOCUMENT (DOLLARS DISPLAYED IN CENTS)	14DEC01 12:40:49	PAGE 1
Issued To: AF MATERIEL COMMAND DIR OF BUDGET APMC 4375 CHILDLAW RD WP AFB OH	Issued By: SEC, AF FIN MGT SAF/FMS 1130 AF, PENTAGON WASH, DC	SUSPENSE NUMBER 0130-02-1833-02-000A-00227	ADVICE NUMBER 02-000A-00130 SERVICE SERIAL 02-000A-00130
EFFECTIVE DATE 14DEC2001 ISSUE DATE 14DEC2001	ISSUER ACCOUNTING CODE PAO RECIPIENT ACCOUNTING CODE 47	FISCAL STATION EROC: UIC:	AUTHORITY CHANGE 0130-02-000A-00001
SECTION A PROGRAM	PREVIOUS BALANCE	CHANGE THIS DOCUMENT	REVISED AMOUNT
DIRECT 48 IM/IT DEVELOPMENT (TMA) RPG KEY: A	0.00	702,000.00	702,000.00
SUM OF DIRECT	0.00	702,000.00	702,000.00
REIMBURSABLE	0.00	0.00	0.00
SUM OF REIMB PROGRAM	0.00	0.00	0.00
SECTION B AUTHORITY	PREVIOUS BALANCE	CHANGE THIS DOCUMENT	REVISED AMOUNT
BUDGET AUTHORITY	0.00	702,000.00	702,000.00
REIMBURSABLE AUTHORITY	0.00	0.00	0.00
SECTION C LIMITATIONS	PREVIOUS BALANCE	INCREASE/DECREASE	REVISED NET AMOUNT

Funding is distributed to program managers in the form of a FAD. This document specifies the appropriation for which the funds are authorized to be used, the effective date, the specific quarter in which the funds are available for use, and at what amount.

In Section A, the funds are broken down into the specific program for which the funds are authorized and whether that funding is to be direct or reimbursable.

Footnotes on the second page of the document provide information on specific authority to perform work on an automatic reimbursable basis based on acceptance of customer orders, and any other comments concerning targets, restrictions, or limitations that apply to the funds listed on the first page of the document.

Now let's talk about the ADA.



Anti-Deficiency Act

Events that may signal possible violations:

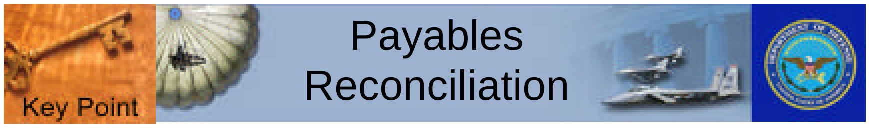
- **Obligating the government without authority**
- **Over-committing or over-obligating funds**
- **Contracting or obligating money before it is available**
- **Deliberate failure or delay in posting to avoid over-obligation or over-expenditure**
- **Disbursement in excess of authorized funding**
- **Exceeding funding limitations**

The ADA, Title 31, United States Code (USC), Section 1517, prohibits any officer or employee of the government from obligating or spending more money than has been appropriated, except as authorized by law. Although as accounting personnel you are not normally in violation of this act due to the separation of duties between the purchasing and accounting processes, you must be aware of the possibility of their occurrence.

SFFAS No. 1, Paragraph 80, requires the reporting entity to disclose Accounts Payable not covered by budgetary resources. This reporting is a part of the Department's PAR, though it is rare that a report is other than a negative (no occurrence) report.

Possible violations would be investigated before a violation of the law is assumed as the appearance of a violation could be the result of input errors or errors in posting, in which case the corrections would be made.

Let's move on to Payables Reconciliation.



Benefits of Reconciliation

- **Timely payment of debts**
- **Ensure funds availability to cover liabilities**
- **Prevention of Anti-Deficiency Act violations**
- **Availability of documentation to support an audit**
- **Accurate reporting for management purposes**

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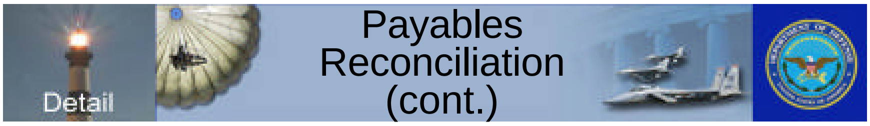
The payable reconciliation process is important to ensure the timely payment of liabilities incurred by the Department and to prevent ADA violations due to delayed processing or reporting of transactions. In relation to the audit of Accounts Payable, it is to the DFAS Vendor Pay Office that the auditor will request information on the payables that are reported.

The significance of Accounts Payable, even though for some DoD Components the actual balance in Accounts Payable as shown on the financial statements is not material, is that when you record an Accounts Payable transaction, you are also debiting an asset or expense account. Examples of asset accounts are Fund Balance With Treasury (FBWT), and General Property, Plant, and Equipment (PP&E). Examples of expenses are supplies, travel, transportation, rent, or utilities. Accurate reporting is critical to the determination of the cost of operations of the Department. If you don't get Accounts Payable right, the you won't get assets and expenses right.

Let's look at the payable reconciliation process.



Payables Reconciliation (cont.)

Reconciliation Process

- **Review requirements**
- **Duties and responsibilities**
- **Reconciliation reports**

Reference: SOP DFAS-AA/CA-7000.033 – Accounts Payable Review/Reconciliation, September 2002

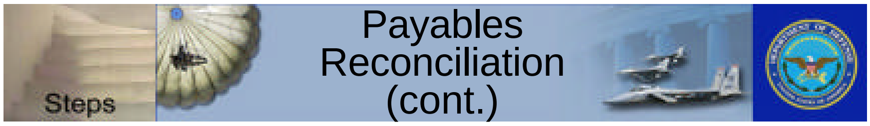
During the payable reconciliation process, we first review requirements and the duties and responsibilities of individuals involved in the process, then follow up with a look at the reports and the specific procedures involved.

For this process, an SOP out of the Columbus Center was particularly helpful in addressing several reports, procedures, responsibilities, and requirements. Not all of these procedures may apply to your operation.

According to the SOP DFAS-AA/CA-7000.33 – Accounts Payable Review/Reconciliation, dated September 2002, payables are reviewed for timeliness, accuracy, and completeness during the Tri-annual Reviews of Commitments and Obligations conducted by fund holders with assistance from supporting accounting offices. The requirement for these reviews apply not only to direct appropriations, but also to all reimbursable transactions, as well as the Departments revolving and trust funds.

During this review it is important to note an Accounts Payable is a stage of an obligation, but an obligation is not necessarily an Accounts Payable. The documentation reviewed for an Accounts Payable begins with the actual purchase transaction. Accounts Payable are reconciled to their supporting documentation and any discrepancies are noted, researched, and any necessary adjustments are fully documented.

Let's talk about the requirements for this review and reconciliation process.



Payables Reconciliation (cont.)

Example of Aging of Payables

Aging Period	Number of Days
0 to 30 days	30
31 to 60 days	60
61 to 90 days	90
91 to 120 days	120
121 to 150 days	150
151 to 180 days	180
181 days and over	181+

According to SFFAS No. 1, Paragraph 77, when an entity accepts title to goods, whether the goods are delivered or in-transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated.

Accounts Payable are categorized into Delivered Orders – Unpaid, also known as AEU and are aged in 30-day increments until they are greater than 180 days old.

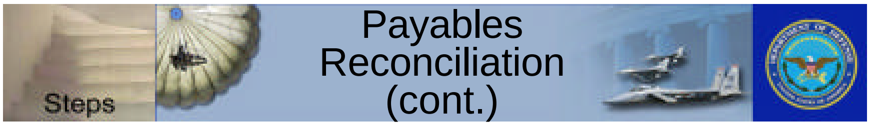
Accounts Payable recorded in error are reversed. Accounts Payable that are unrecorded due to oversight are paid in accordance with the documentation. Late payment of bills by the Department's activities are subject to the provisions of the Prompt Payment Act and require the activity to charge the interest penalty payable to the appropriate account.

Outstanding payables for which contractual information exists are recorded in the appropriate payable account (government or public) and processed based on the contract administrator documentation or Administrative Contracting Officer (ACO) or Procurement Contracting Officer (PCO) certification.

Supporting documentation for Accounts Payable in any given accounting period are developed, updated, and retained for reporting and audit purposes.

The Access Database download from the AEU Report or the Real Time Expenditure Listing Report should be used to perform the required Tri-annual Reviews.

Let's consider the responsibilities for the reconciliation of Accounts Payable.



Payables Reconciliation (cont.)

Accounting Directorate Associates Duties

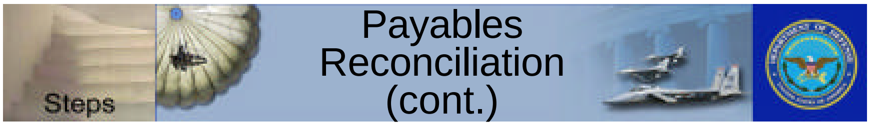
- **Provide listing(s) of outstanding commitments and unliquidated obligations**
- **Assist with reviews by:**
  1. **Grouping transactions to facilitate segmented review**
  2. **Facilitating the identification and correction of delays**
  3. **Entering identified and supported corrections**

In the Tri-annual Reviews of Commitments and Obligations, fund holders ensure the accuracy of data in the system. Assistance may be provided by accounting directorate associates in various DFAS Accounting Divisions.

DFAS is responsible for processing, reporting, and tracking data provided by the services through the system to the General Ledger. The appropriate DFAS accounting office provides the fund holder with listing(s) or automated media identifying both outstanding commitments and unliquidated obligations recorded for the fund holder. If requested, the accounting office assists the fund holder in the conduct of the reviews by: (1) assisting in the identification and organization of transactions groupings in such a manner so as to facilitate the review by different segments of the fund holder's organizations; (2) assisting in the identification and correction of situations that may delay the recording of commitments or obligations, or the matching of disbursements to obligations; and (3) entering corrections identified by the fund holder when such corrections are adequately documented and the entry of such transactions is the normal function of the accounting office.

Reconciliation to the financial statements is accomplished quarterly at DFAS. DFAS also conducts annual reviews of data received.

Now let's consider the duties of the fund holder.



Fund Holder Responsibilities

Conduct reviews of:

- **Outstanding commitments and unliquidated obligations – required by DoDFMR, Volume 3, Chapter 8, tri-annually (to include Accounts Receivable and Accounts Payable)**
- **Accrued Expenditures Unpaid**
- **Over-aged obligations**

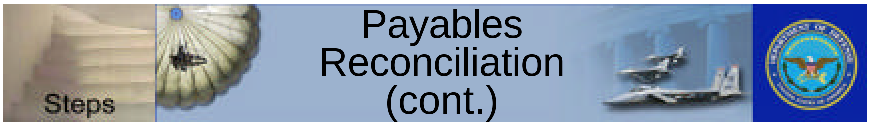
The fund holder conducts reviews of outstanding commitments and unliquidated obligations, irrespective of whether the fund holder or the accounting office actually records the commitments and/or obligations in the official accounting records. This responsibility is placed on the fund holder because the fund holder initiates those actions that result in commitments and obligations and, therefore, is in the best position to determine the accuracy and the status of such transactions. Minimum review requirements are accomplished no later than 14 days following the end of January and May, and by September 30 of each fiscal year.

These Tri-Annual Reviews have dollar thresholds which require the review of items exceeding certain dollar amounts such as $50,000 for Operations and Maintenance (O&M) accounts and $200,000 for Investment accounts. Most Accounts Payable transactions fall below these threshold amounts and fail to be reviewed in a timely manner. However, the requirement states that a 100% review must be performed at least once a year.

In addition, the AEU are reviewed for non-disbursed expenditures, and the aged financial status is reviewed for over-aged obligations.

The Monthly Report of Accounts Payable is reviewed for unpaid obligation balances for goods or services received. Amounts listed are aged from the transaction date the payable was established to the date of the report.

Let's examine specific procedures for the conduct of these reviews.



Payables Reconciliation (cont.)

Payables Review

- **Review open and over-aged payables for validity**
  - **Vendor contact**
  - **Determine payable status**

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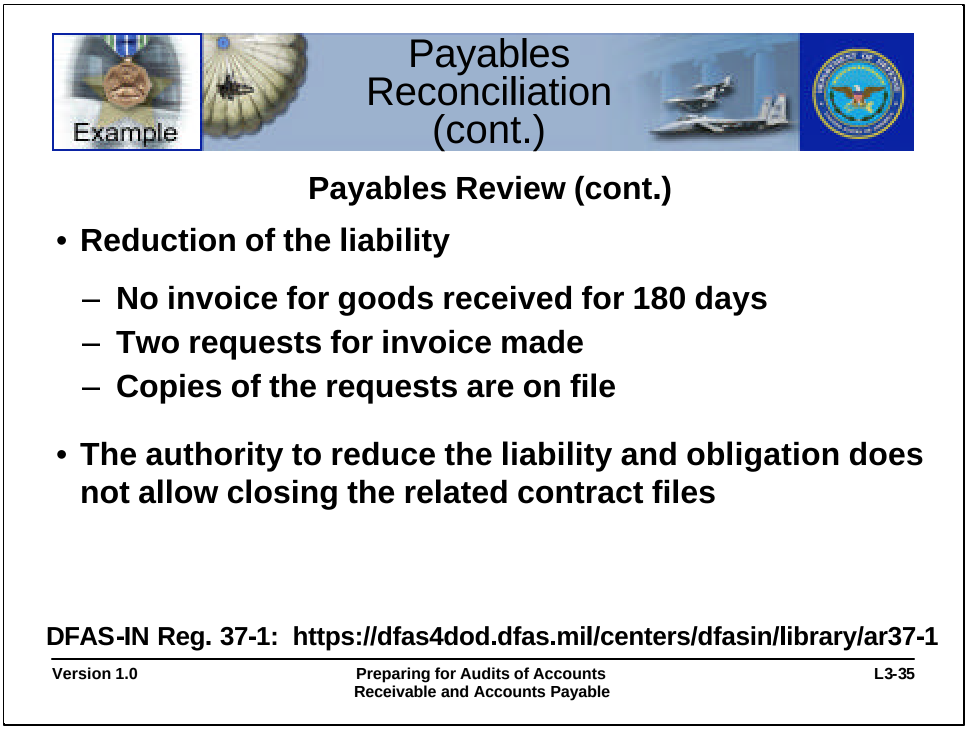
Using the reports just mentioned, the fund holder, with the assistance of DFAS, reviews and follows up on open and over-aged Accounts Payable to determine the validity of the payable. Open accounts payable require constant review to assure that they are valid liabilities.

Normally vendors send an invoice to receive payment for goods shipped. The payable record is cleared once payment is made and the expenditure is recorded. However, there are many Accounts Payable for which no expenditure gets recorded in the system. In these cases, the fund holder contacts the vendor to solicit an invoice, compare records, or obtain the status of the payable (payables age from date of receipt).

Upon receipt of the listing of open accounts payable, active contract files are reviewed. A prompt payment review is performed to determine whether the invoice has been received and inputted, or if the contract is a valid overdue payable.

Now let's examine the next step in the review process.



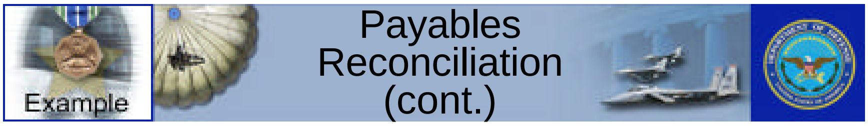
One example of a practice used in the review of payables has been applied to both Columbus (CO) and Indianapolis (IN) operations (refer to the SOP DFAS-AA/CA-7000.33, Accounts Payable Review/Reconciliation and DFAS-IN Regulation 37-1) for contracts or purchase orders placed with commercial vendors, liabilities and related obligations. They may be reduced if:

- goods or services were received but no invoice or statement was received for at least 180 days from the date of acceptance of the goods or services
- at least two written requests were made by the Vendor Pay Office for an invoice during the 180 days and the second request is dated at least 60 days before the reduction of the liability and obligation
- copies of the request are on file in the Vendor Pay Office.

These requests are addressed to the vendor. When the paying and accounting activities are different, the paying activity requests invoices and provides copies to the funded fiscal station.

The Vendor Pay Office notifies the servicing accounting activity and the fund holder when there is no response from the vendor. The authority to reduce the liability and obligation does not allow closing the related contract files in either the purchasing and contracting office or the Vendor Pay Office. Each center develops its own procedures and standards for the review of payables. Before reducing the liability, there are a few more steps.

Let’s look at them.



Payables Reconciliation (cont.)

Before writing off a payable, verify that it has not been paid, or in suspense. Late invoices are matched against previously written off liabilities to determine validity.

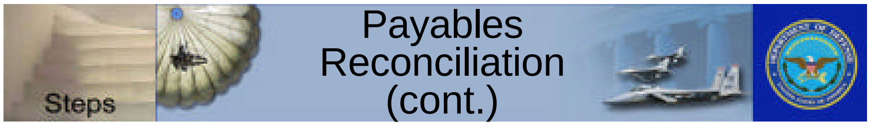
If…	Then…
A late billing is determined to be valid	The liability shall be reestablished and funds obligated and paid from an appropriate account (current appropriation or expired account).
It is an expired account	The payment of a valid late bill shall be treated as an obligation adjustment.
It is a canceled account	The payment of a valid late bill should be from a current account (available for the same purpose as a canceled account) in an amount not to exceed the lesser of any remaining obligated balance of the canceled account or 1% of the current account.

Continuing the example, once the payable is determined to be valid, verify the invoice has not been paid, or is not in suspense. Late invoices received are matched against documentation of liabilities previously reduced to determine their validity before payment. If a contract or order is in litigation, the liability remains on the accounts.

If a late billing is determined to be valid then the liability is reestablished and funds are obligated and paid from an appropriate account (current appropriation or expired account). If it is an expired account then the payment of a valid late bill is treated as an obligation adjustment. If it is a canceled account then the payment of a valid late bill should be from a current account (available for the same purpose as the canceled account) in an amount not to exceed the lesser of any remaining obligated balance of the canceled account or 1% of the current account. Write offs of invalid payables should be input before the end of the month in which processing is done to ensure the contract does not appear on the next month's report.

A portion of the funds available for funding the activity cost center should be reserved within each appropriation or fund for invoices received subsequent to reduction of the liability or write off. The funded amount in reserve for late bills should be established at a level sufficient to preclude violations of the ADA from the receipt of valid late bills. This amount should be reviewed and approved by the comptroller of the activity annually to determine if an adjustment based upon experience is appropriate.

Let's talk about the required supporting documentation.



Payables Reconciliation (cont.)

Supporting documentation on which the appropriate transaction was made is retained in a form to assist audit and reconciliation. It includes:

- **The basis for the amount recorded as a payable**
- **The terms upon which payment is to be made**
- **All reports, memos of telephone conversations and notes of research maintained in the customer folder**

Supporting documentation includes the amount recorded as a payable, the terms upon which payment is to be made, and all reports, memos of telephone conversations, and notes of research maintained in the customer folder.

Now that you've learned about the review of payables for validity, let's move on to reviewing open payables for any abnormal conditions.

Steps

Payables Reconciliation (cont.)

Causes of abnormal conditions include:

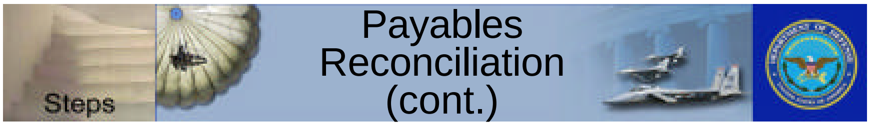
- **Accounting system interface problems**
- **Supporting document errors**
- **Program director input errors or failure to review output**
- **Erroneous processing of transactions by others**
- **Foreign currency fluctuations**
- **Accounting input errors**

Open payables are examined to determine if there are any abnormal conditions. Abnormalities may be the result of accounting system interface problems, supporting document errors, program director input errors or failure to review output, erroneous processing of transactions by others, foreign currency fluctuations, or accounting input errors.

These may result in unfunded payables. Unfunded payables require the transfer of funding to the appropriate program in order to complete the processing of the payable transaction in some systems. Obligation adjustments may also be required to ensure that funds that are no longer required are freed for further use. Evidence of an unfunded payable may also be an indication of fraud.

Accrued expenditures are either paid or unpaid. When goods or services are received, expenditures are accrued. Entries to the budgetary general ledger accounts require a corresponding entry to the proprietary general ledger accounts for assets, liabilities, and net position.

Let's discuss the documentation requirements to support the accomplishment of the review and reconciliation.



Supporting Documentation

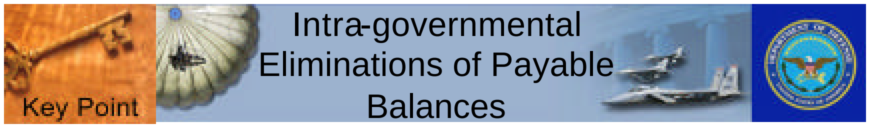
Fund holders are required to maintain documentation that is sufficient to permit independent auditors to verify that the reviews were accomplished as required for a period of 24 months, following the completion of the review.

Documentation to support the review of Accrued Expenditures Unpaid is available from DFAS Commercial Accounts and Travel. For obligations (undelivered orders and AEU), the sample records are matched to the contract files to determine the legitimacy of the payable.

All required adjustments or corrections are identified during the review and should be documented and processed within 10 working days of their identification by responsible individuals.

Fund holders are required to maintain documentation that is sufficient to permit independent auditors to verify that the reviews were accomplished as required for a period of 24 months following the completion of the review.

Now let's discuss intra-governmental eliminations of payable balances.



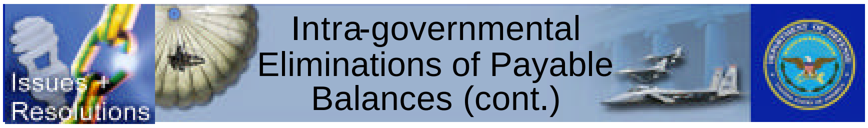
Intra-governmental Eliminations of Payable Balances

- **Issues and resolutions concerning intra-governmental eliminations of payable balances**
- **Disputed or delinquent intra-governmental payables**

The Intra-governmental Elimination of Payable Balances topic covers the issues and resolution of payable balances and processes used when there is a dispute over payables between federal government entities or delinquent payment of intra-governmental payables.

We previously defined intra-governmental transactions as transactions among federal entities.

Let's consider some issues related to these balances.



Weaknesses

- **The task to separately report Accounts Payable owed to other federal agencies from those owed to the public wasn't complete and ready for audit because there was no audit trail for transactions posted directly to the general ledger at the departmental level. These transactions concerned transactions recorded by general open allotments and transactions recorded using journal vouchers.**

Resolutions

- **The DFAS Strategic Targets Operating Plan, dated April 18, 2005, addresses the critical initiative to ensure that all intra-governmental Accounts Payable are identified, supported, recorded, and reconciled to the financial statements.**

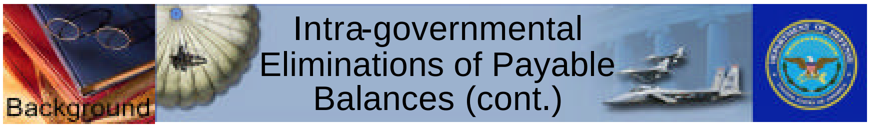
A recent audit report concerning the validation of completed tasks for Accounts Payable found that the task to separately report Accounts Payable owed to other federal agencies from those owed to the public wasn't complete and ready for audit because all transactions couldn't be selected for audit.

They found that Accounts Payable from the financial statements to the General Ledger Trial Balance to transactions in the field systems were traceable, but there was no audit trail for transactions posted directly to the General Ledger at the departmental level. These concerned transactions recorded by general open allotments, and transactions recorded using journal vouchers. Emphasis must be placed on the retention of supporting documentation.

The DFAS Strategic Targets Operating Plan dated April 18, 2005, addresses the critical initiative to ensure that all intra-governmental Accounts Payable are identified, supported, recorded, and reconciled to the financial statements.

Once a transaction is identified as an intra-governmental transaction, it is reported separately from Accounts Payable due to public entities and specific payment procedures are applied.

Let's examine a few of those differences.



Intra-governmental Eliminations of Payable Balances (cont.)

Provisions of the Prompt Payment Act are not applicable to intra-governmental payables. Systems used to transfer funds for payable transactions include:

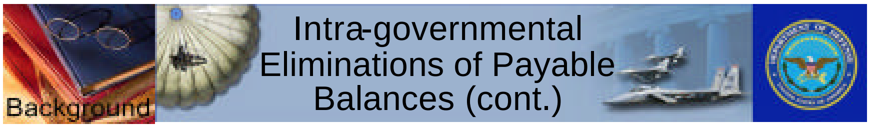
- **Treasury's Inter-governmental Payment and Collection (IPAC) System**
- **Intra-governmental charge card methods**
- **Standard Form (SF) 1080, Voucher for Transfer between Appropriations and/or Funds**

Provisions of the Prompt Payment Act are not applicable to intra-governmental payables, therefore interest, and additional interest penalties are not applied to payments between entities of the federal government.

The due date for Accounts Payable due to wholesale stock funds transactions is established at 30 days, while payables for transportation bills are charged directly to the applicable line of accounting of the entity receiving the service, if available. Systems used to transfer funds for payable transactions include the Treasury's Inter-governmental Payment and Collecting (IPAC) system, and intra-governmental charge card methods as well as the Standard Form (SF) 1080, Voucher for Transfer between Appropriations and/or Funds. Remittance by check between federal agencies is used as a last resort.

Payment for ordered goods and services should be made promptly on the written request of the activity filling the order. Payment may be made in advance or upon receipt of the goods or services ordered. Payment may be based on any part of estimated or actual cost as determined by the activity filling the order. A bill submitted or a request for payment is paid promptly and not postponed subject to audit or other similar validation in advance of payment. This provision is not intended to preclude questions on the accuracy and correctness of the billed amounts. The intent is to preclude the nonpayment of bills while billing details are being resolved.

Let's discuss the resolution of disputed payables.



Intra-governmental Eliminations of Payable Balances (cont.)

- **Every effort should be expended to resolve disputed intra-governmental payables within 60 days**
- **To dispute an intra-governmental bill, you must provide the performing entity's Accounts Receivable office a letter showing cause for nonpayment not later than 30 days after the date of the bill**
- **The only valid causes for disputed billings is lack of supporting documentation or authority to bill, non-receipt of goods or services, or duplicate billing**
- **Failure to provide the letter within 30 days will result in the required acceptance of the charge**

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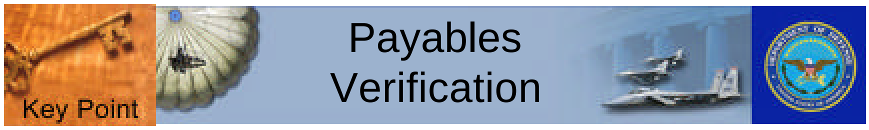
Every effort should be expended to resolve disputed payables within 60 days. For transactions within the Department, if after 60 days an agreement as to the resolution of billing details cannot be reached, the billing activity may request adjudication from the Office of the Deputy Comptroller, Program Budget (ODC(P/B)). Disputes between governmental agencies (outside the DoD) are forwarded to the performer's Component Comptroller or designee for review only after appropriate research and collection actions have been performed.

To dispute an intra-governmental bill, you must provide the performing entity's Accounts Receivable office a letter showing cause for nonpayment not later than 30 days after the date of the bill. The only valid causes for disputed billings is lack of supporting documentation or authority to bill, non-receipt of goods or services, or duplicate billing. If requested, the performing entity's Accounts Receivable office provides a copy of the bill and the supporting documentation.

Failure to provide the letter within 30 days will result in the required acceptance of the charge.

Now let's talk about payables verification.



Payables Verification

Verification processes:

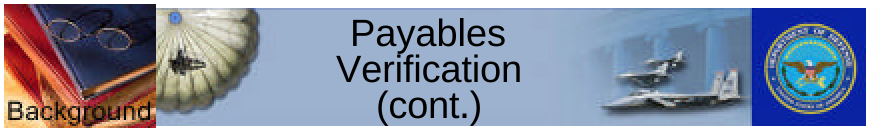
- **Management assertions**
- **Aging reports**
- **Metrics**

Audit tools:

- **Government Accountability Office (GAO)/ President's Council on Integrity and Efficiency (PCIE) Financial Audit Manual (FAM)**
- **Common procedures**

In this topic we cover the verification processes for payables balances and the roles and responsibilities for validation. We then discuss audit processes that relate to Accounts Payable and provide examples of proposed solutions for the validation and assertion of Accounts Payable balances.

Let's begin with a look at verification processes.

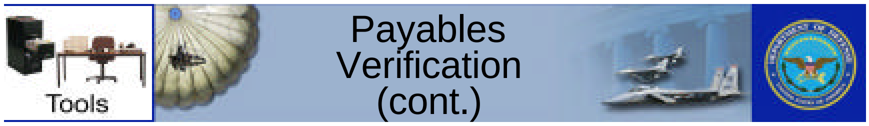


Management Assertions

- **Existence or Occurrence**
- **Completeness**
- **Rights and Obligations**
- **Valuation or Allocation**
- **Presentation and Disclosure**

Verification processes for payables are used to verify that the amounts reported as Accounts Payable are supported by adequate documentation that evidences the existence or occurrence of a valid transaction. The processes used verify that all Accounts Payable have been recorded to include any unfunded payables and that the payable is a bona-fide obligation of your entity. The processes are also used to verify that the Accounts Payable are recorded in the correct amount, and if the amount recorded is an estimate, that the estimate is based on your entity's engineering and management evaluation of actual performance progress and incurred costs, and that the Accounts Payable are presented in the financial statements in accordance with Generally Accepted Accounting Principles (GAAP).

Let's discuss the tools available to you to verify these assertions in preparation for an audit of your Accounts Payable.



Payables Verification (cont.)

Reconciliation Reports:

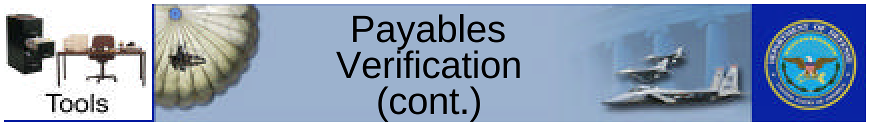
- **The Accrued Expenditures - Unpaid are reviewed for non-disbursed expenditures, and the aged financial status is reviewed for over-aged obligations**

- **The Monthly Report of Accounts Payable is reviewed for unpaid obligation balances for goods or services received. Amounts listed are aged from the transaction date the payable was established to the date of the report**

At Columbus, reports used in the reconciliation of Accounts Payable (mentioned earlier) are valuable tools in the verification process as well. Any unusual balances should be investigated for accounting errors, data entry errors, outstanding documentation, cancelled orders, possible violations of the ADA, or late payments subject to the Prompt Payment Act.

An overage payables listing is used to identify those payables over 90 days old. It should provide a listing of account payable lines; detail to support quantities used in the payable computations; and a summary of payable dollar value totals by age and paying office.

One tool that is used by the auditor in the performance of the financial statement audit is also available to you. Let's examine a portion of the Financial Audit Manual (FAM) that concerns Accounts Payable.



Use of the GAO/PCIE Financial Audit Manual

Section III Balance Sheet

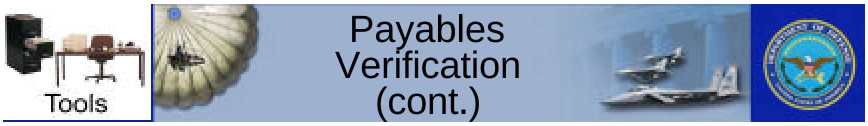
The questions related to the balance sheet are contained under 23 line items. The question numbers related to each line item follow.

Item	Line Item	Question Numbers
	Assets	
1. … 3. …	Fund Balance with Treasury ….. Accounts Receivable (Net) …	7-22 … 33-49 …
	Liabilities	
17.	Accounts Payable and Interest Payable	273-280
…	…	…
22.	Other Liabilities	320-353

GAO/PCIE FAM: http://www.gao.gov/special.pubs/01765G/

Using Part II of the FAM, you may view checklists of questions that are designed to verify your Accounts Payable. Notice that questions 273 through 280 concern Accounts Payable and Interest Payable.

Let’s examine some of the questions related to Accounts Payable and Interest Payable.



Use of the GAO/PCIE Financial Audit Manual (cont.)

Questions related to Accounts Payable

Item	Question	Auditor Response
273	Do accounts payable exclude amounts related to ongoing continuous expenses, such as salary and related benefits expense, which are classified as other current liabilities? (SFFAS 1, par.75)	
274	Are (intra-governmental) accounts payable owed to other federal agencies reported separately from those owed to the public? (SFFAS 1, par. 76; OMB Bull. 01-09, p. 18, section 3.2 & p. 24, section 3.4)	
275	When an entity accepts title to goods, whether the goods are delivered or in transit, does the entity recognize a liability for the unpaid cost of the goods? (SFFAS 1, par. 77)	
276	If invoices for goods, for which the entity has accepted the title, are not available, does the entity estimate the amount owed? (SFFAS 1, par. 77)	

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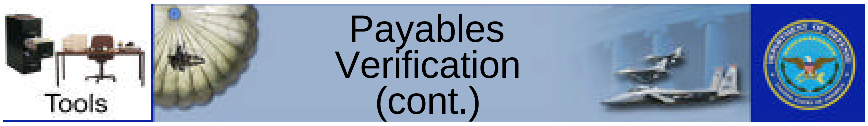
Notice that question 273 concerns the proper classification of transactions. Amounts related to ongoing continuous expenses are classified as current liabilities.

Question 274 requires the entity to separate those payable transactions for federal entities from those with the public.

Question 275 concerns the date of recognition of the liability associated with the Account Payable, and question 276 refers to the estimation of an amount owed when an invoice is not yet available.

Some questions will not be applicable to your entity and may be skipped. You may set up checklists of applicable questions to use in an evaluation of your payables process.

Let's look at a few more questions.



Use of the GAO/PCIE Financial Audit Manual (cont.)

Item	Question	Auditor Response
277	For facilities or equipment constructed or manufactured by contractors or grantees according to agreements or contract specifications, are amounts recorded as payable based on an estimate of work completed under the contract or the agreement in accordance with the federal entity's engineering and management evaluation of actual performance progress and incurred costs? (SFFAS 1, par. 78 & 79)	
278	Does the entity disclose accounts payable not covered by budgetary resources? (SFFAS 1, par. 80; OMB Bulletin 01-09, p. 24, section 3.4; p. 78, section 9.12)	
279	Is interest incurred but unpaid on borrowed funds, late payments, and refunds recognized as interest payable and reported as a liability at the end of each period? (SFFAS 1, par. 81; OMB Bulletin 01-09, p. 24, section 3.4)	
280	Is interest payable to federal entities reported separately from interest payable to the public? (SFFAS 1, par. 82)	

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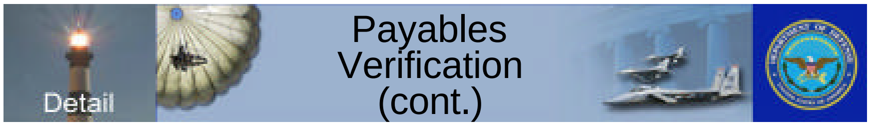
Notice that question 277 concerns the recording of amounts due based on the estimate of work completed under a facilities or equipment construction contract.

Question 278 discusses required disclosure of Accounts Payable not covered by budgetary resources. This is not a normal condition and is rare in occurrence.

Both questions 279 and 280 concern interest payable.

There are a couple of procedures that are common to the verification process. Let's talk about them.



Payables Verification (cont.)

Common Procedures for Account Verification

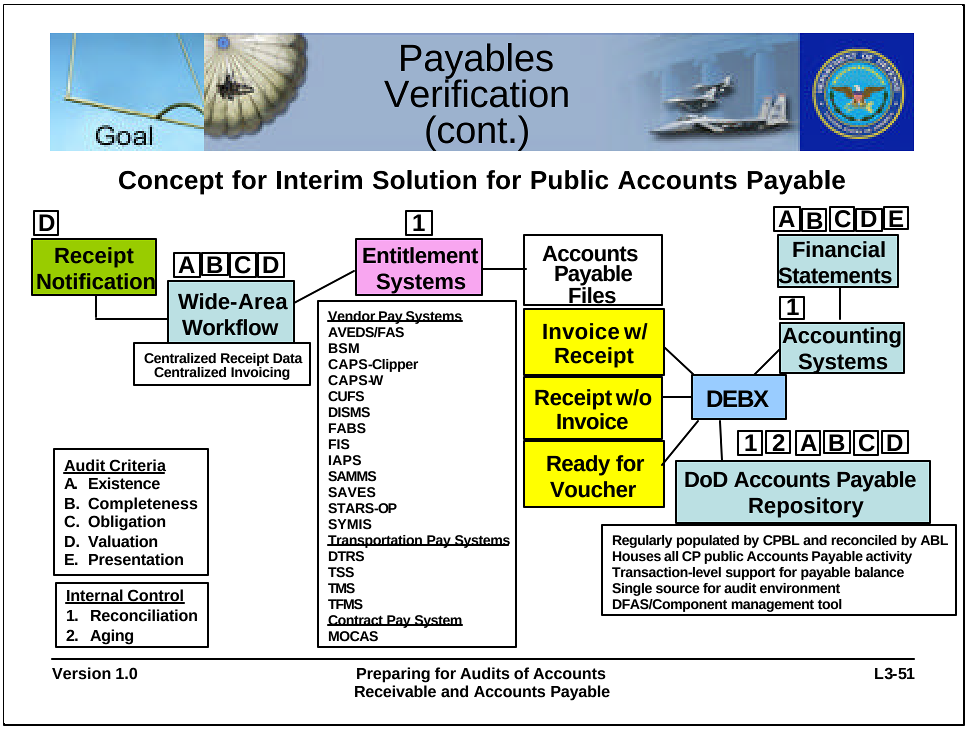
- **Tests of transaction details**
- **Documentation of processes**
- **Communication**

A universe of transactions should be available and audit trails must provide for ready identification and access to documentation supporting the transactions in the universe. If supporting documentation exists, but cannot be identified or readily retrieved in a timely manner, the audit trail is insufficient for the validation. You should test the details by sampling of transactions that are the basis for the amounts reported on the financial statements. The auditor randomly samples 45 or more Accounts Payable transactions in order to determine the risk of not detecting material misstatements of Accounts Payable balances. Based on the assessed level of risk, the auditor determines the specific audit procedures that are needed to validate your Accounts Payables.

Documentation of processes is useful in validation to ensure that you are able to establish an audit trail. To test the details of a reported amount, you must understand how data is pulled from each source to be eventually reported on a single line of the Balance Sheet. A Performance, Analysis, and Design (PAD) describes the process in common language and provides a graphic depiction of the systems, manual inputs, controls, decision points, outputs, and file locations.

In addition to mapping processes, reconciling reports, and evaluating procedures, communication is a key tool in the verification of payables. You must communicate with everyone involved in the process from the receiving entity to the vendor; to the accounting technician; to the fund holder; and others.

A proposed concept for the long-term solution for public accounts payable involves the visibility of transaction detail throughout the payables process. Let's look at this proposal.

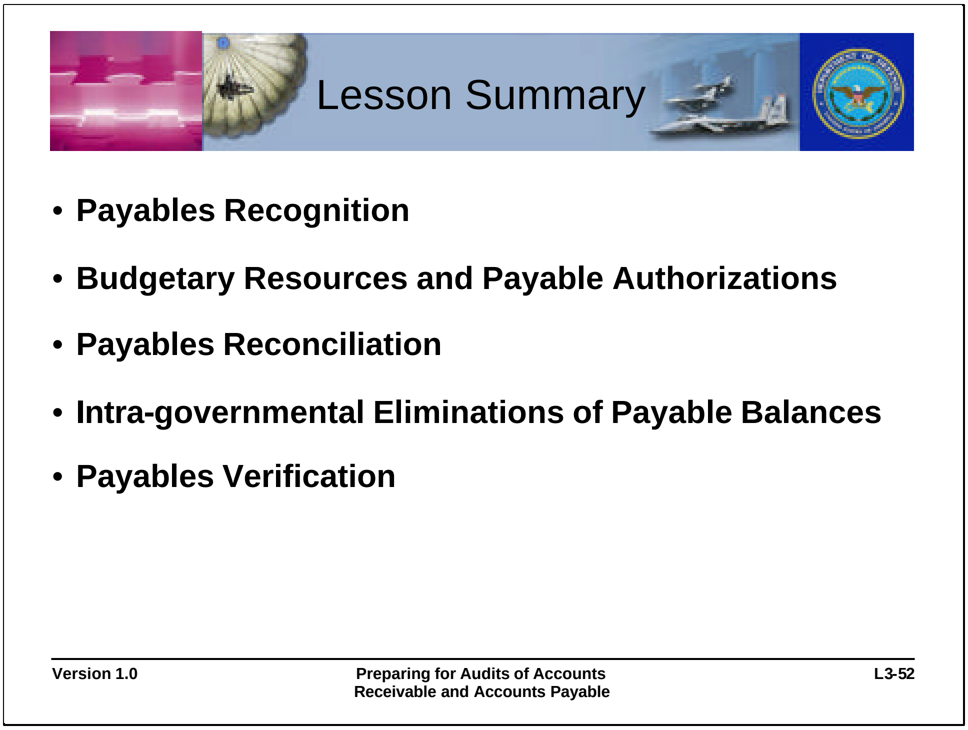


The concept for an interim solution for Public Accounts Payable involves the addition of a Database Exchange (DEBX) that acts as a conduit to the repository for DoD Accounts Payable transaction history.

Current processes require a manual interface to provide visibility to transaction information that is consolidated in reported data. To be able to audit a reported amount, that amount must be able to be broken down into its individual components.

Notice that the addition of the DEBX would allow the auditor to access transaction histories from a single source and enable validation of the existence, completeness, obligation, and valuation assertions. It would also allow easier reconciliation and aging of Accounts Payable.

Now let's summarize what we've learned in this lesson.



In this lesson, you learned that payables are recognized at the time of transfer of the associated assets. We discussed the sources of payables transactions and document handling procedures to include file maintenance, internal control techniques, and SOPs. We then discussed the provisions of the Prompt Payment Act.

In Budgetary Resources and Payable Authorizations, we discussed the PBAS and AFM systems, and FADs. We also discussed common indicators of violations of the ADA.

In Payables Reconciliation, we talked about reconciliation reports and duties and responsibilities for the reconciliation process.

You found that identification of intra-governmental payables allows for their elimination and that disputed intra-governmental payables require a letter within 30 days to the performing entity's accounts receivable office.

In Payables Verification, we discussed tools such as reconciliation reports and audit tools that are available to you such as the FAM. We also discussed some common procedures for account verification to include tests of transaction details, documentation of processes, and communication.

The following slide lists references available for additional information.

References

SFFAS No. 1: http://www.fasab.gov/pdffiles/sffas-1.pdf

SFFAS No. 5: http://www.fasab.gov/pdffiles/sffas-5.pdf

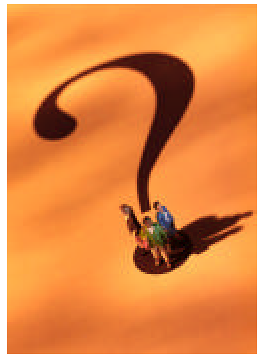
NARA GRS: http:www.archives.gov/records-mgmt/ardor

DFAS-IN Regulation 37-1:
https://dfas4dod.dfas.mil/centers/dfasin/library/ar37-1

GAO/PCIE FAM:
http://www.gao.gov/special.pubs/gaopcie

Prompt Payment Act: http://www.fms.treas.gov/prompt/

Questions



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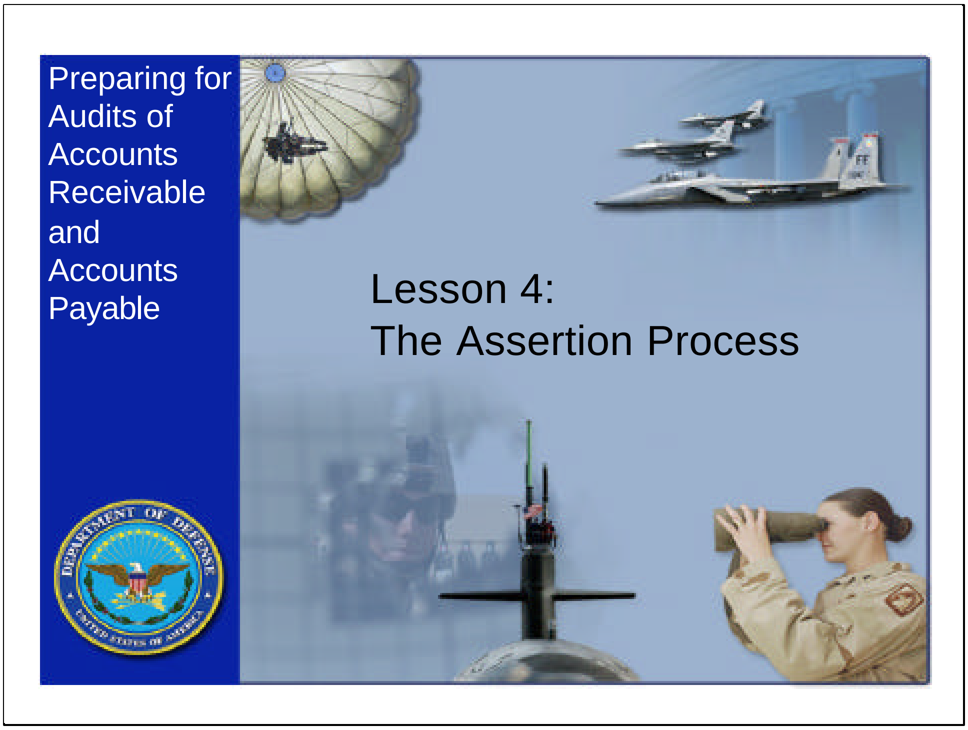
Before we move on to Lesson 4, The Assertion Process, do you have any questions on the material covered in this lesson?



In Lesson 4, we discuss the five-phase process used by the Department's leadership to move it's entities' financial statements from a position of unreliable to reliable, and, ultimately, to an unqualified audit opinion.

Let's discuss the lesson objective.

Lesson Objective

Upon successful completion of this lesson, you will be able to identify the steps to prepare for the assertion of Accounts Receivable and Accounts Payable.

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This lesson will help you to identify the steps necessary to prepare for the assertion of Accounts Receivable and Accounts Payable.

Section 1008 of the National Defense Authorization Act for Fiscal Year (FY) 2002 required that the Office of the Under Secretary of Defense, Comptroller (OUSD(C)) assess the reliability of the Department's financial statements.

For those statements represented to be unreliable, the OUSD(C) redirected resources expended on financial statements preparation to efforts toward improving the entity's ability to report reliable financial information.

Let's look at the lesson topics.

This lesson contains the following topics:

- **Overview**
- **Discovery and Correction**
- **Validation**
- **Assertion**
- **Assessment**
- **Audit**

The Department is pursuing the challenge of improving financial management through several initiatives, including the Financial Improvement Initiative. This Financial Improvement Initiative is a five-phase process designed to prepare entities to pass a financial audit and to improve their ability to control and report on their financial activities.

According to the OUSD(C) Memorandum dated June 23, 2004, Subject: Financial Improvement Initiative Business Rules, the process for preparing for an unqualified audit opinion is described within the Discovery and Correction, Validation, Assertion, Assessment, and Audit Phases. These phases are the focus of this lesson.

Let's begin with an overview of this five-phase process.

Major Phases

Discovery and Correction	Validation	Assertion	Assessment	Audit
WHY • Discover problems • Evaluate solutions • Plan solutions • Correct processes • Complete policy HOW • Develop improvement plans • Establish audit committees • Develop systems strategy • Prepare business cases for systems changes • Prepare and review full set of financial statements each quarter	WHY • Enhance credibility of assertions HOW • Management documents processes, identifies controls & systems, and ensures auditable universe of transactions & supporting documentation is available • Management requests validation of financial information ▪ Performed by internal review, component's audit agencies, or external audit firm	WHY • Communicate to DoD OIG and auditors reliability of financial information HOW • Assertion letter to DoD OIG that: 1. Responds to DoD OIG's instructions 2. Includes checklist 3. Includes results of validation and reports • Engagement letter and management representative letter, if used • Memo to DoD OIG, and to OUSD (C) RPS • ESC approval for assessment/audit	WHY • Allows remediation • Attests to management assertion • Plan audit • Reduce risk of unknowns (auditor) • Introduction to organization (auditors) HOW • DoD OIG oversight of IPAs • DoD OIG in-house	WHY • Implement CFO Act • Implement 1008 • Presidents' Management Agenda HOW • Pass assessment • DoD OIG oversight of IPAs

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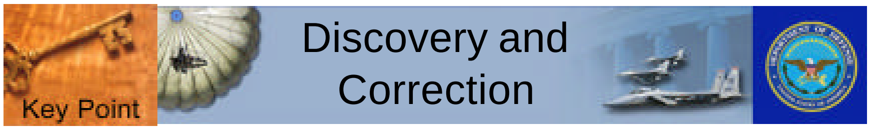
The scope of the Financial Improvement Initiative Business Rules encompass policies, processes, controls, defense business systems, personnel, organizations, performance metrics, and auditor assessments and audits that are directly or indirectly related to DoD financial management.

The process begins with the Discovery and Correction Phase in which management identified deficiencies and implements corrective actions. The Validation Phase requires management to validate the financial information after corrective actions have been completed. The Assertion Phase is when management affirms to the Department of Defense Office of the Inspector General (DoD OIG) their preparedness for an assessment of the asserted financial information. In the Assessment Phase, the DoD OIG or Independent Public Accountants (IPAs) review financial information to determine if it is ready for audit. The final phase is the Audit Phase. DoD OIG auditors or IPAs audit the organization's financial statements that management asserted were ready for audit.

Let's talk about the Discovery and Correction Phase.



Discovery and Correction Phase

Entities identify problem areas or deficiencies, and then develop solutions to those problems.

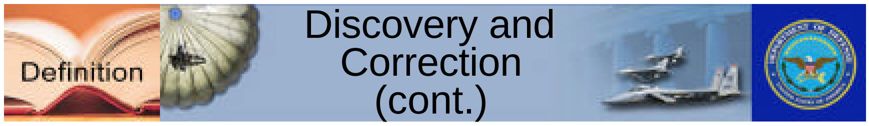
Why	How
Discover problems, evaluate solutions, plan solutions, correct processes, and complete policy.	Develop improvement plans, establish audit committees, develop systems strategy, prepare business cases for systems changes, prepare and review a full set of financial statements each quarter.

The purpose of the Discovery and Correction Phase is to correct deficiencies and plan solutions to produce accurate data.

Each entity must identify problem areas or deficiencies, and then develop solutions to those problems. Problems may be identified from prior assessments or audits, analysis, tests of controls, or internal reviews of operations and procedures. They may include DoD issues and systems, issues affecting your subordinate organizations (your suballotees), or issues that are internal to your operation. After the problems are identified, entities develop plans for corrective action.

These plans must include responsibility, milestones, and required resources. They should take into account the plans of your subordinate organizations and may depend on the plans of higher organizations or operations. You must monitor progress both within and outside of your organization to ensure that milestones are reached. Resources outside of your organization may be available to you, and solutions found by other organizations may be applicable to problems within your operation. Plans for corrective action may already be initiated on deficiencies found on previous audits and assessments and new problems may be identified during their correction.

Let's break this phase down into its two components, discovery and correction.



Discovery and Correction (cont.)

Discovery identifies obstacles and prepares corrective action plans in pursuit of an unqualified audit opinion.

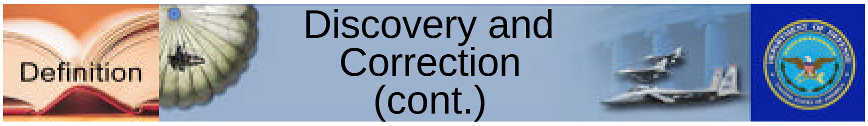
- **Prepare the financial improvement plans**
- **Identify all known deficiencies**
- **Consider whether systemic problems exist**
- **Prepare process flow diagrams**

The purpose of the discovery component is to identify obstacles that could prevent your entity from obtaining an unqualified audit opinion and to prepare improvement plans with solutions that have measurable outcomes for overcoming those obstacles. Measurable outcomes may be shown as metrics, such as the ones discussed in earlier lessons.

Managers and staff should be encouraged to identify and report deficiencies, as this reflects positively on the organization’s commitment to recognizing and addressing management problems. Failing to report a known deficiency would reflect adversely on your organization. You should carefully consider whether systemic problems exist that adversely affect management controls across organizational or program lines. Management should prepare process flow diagrams that include internal control and system interfaces about your Accounts Receivable and Accounts Payable processes.

In this portion of the Discovery and Correction Phase, you should prepare the financial improvement plans for achieving an unqualified audit opinion of your financial statements. In these plans identify, by financial statement line item, all known deficiencies relating to the item, including accounts requiring correction and processes requiring improvement.

Let’s learn more about what is involved in discovery.



Discovery and Correction (cont.)

Discovery (cont.):

- **Identify material weaknesses**
- **Prepare corrective action plans**
- **Implement corrective action**
- **Incorporate effective oversight**

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To prioritize corrective actions, you should identify deficiencies that have a material impact on the financial statements. Then prepare comprehensive corrective action plans to resolve the identified deficiencies. Plans must identify how staff (human capital), processes, or business systems would be changed to implement corrective actions similarly to the proposed system changes discussed in Lesson 3, Accounts Payable.

Implemented plans must then incorporate effective oversight mechanisms to ensure that they are carried out and that the corrections are sustainable. Additionally, you must base milestones on actual estimates of the effort required and identify critical task dependencies.

Corrective action plans should include any requirements for systems audits that would need to be performed. Systems audits ensure that financial reporting systems are reliable. If current systems must be modified and the modifications are part of the corrective actions, prepare a business case to support the modification, and advise the assigned OUSD(C) Point of Contact (POC).

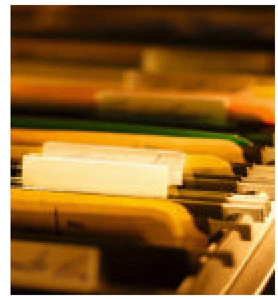
Let's explore some areas where problems are found.

Discovery and Correction (cont.)

Detail

Sources of Weaknesses

- Audit/inspection reports
- Lessons learned
- Policy, procedure, and process reviews
- Hot-line reports
- Actual analysis



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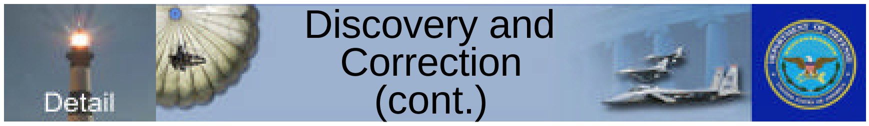
Problems are found on audit and inspection reports, from lessons learned in similar organizations, or from reviews of policies, procedures, and processes. They are also discovered through analysis of financial information, documentation, and systems, such as your monthly and quarterly reconciliations, verification procedures, and documentation reviews. The establishment of a hot-line to report deficiencies, such as those used to capture fraud, waste, and abuse information without fear of reprisal, may also be a source for the identification of material weaknesses.

Similar entities may experience problems in areas that were not found on previous inspections or audits of your entity. Also, reviewing the findings of other entities may provide areas of needed improvement in your own organization.

You should review policies, procedures, and processes to ensure that they are compliant with legal and regulatory guidance, and that they ensure adequate controls over your resources. New procedures may be required in the absence of pre-existing procedural guidance, especially in areas of high personnel turnover, complicated processes, or high-value and/or highly pilferable asset use, such as cash and electronics.

Let’s continue with these sources.



Sources of Weaknesses (cont.)

- **Analyze transactions and balances**
- **Trace transactions from origin to consolidation in financial statements**
- **Use available resources to perform systems analysis**

Analysis of financial information, documentation, and systems is used to identify unusual balances or entries, document trails, and areas of inadequate documentation and system controls. Unusual balances or entries may be the result of failure of a policy, procedure, control, or fraud.

Instances of when complete documentation doesn't exist to be able to trace transactions from their origin to their consolidation into the financial statements must be identified. An analysis of the documentation required for transaction types assists in making this identification, such as the sales record, record of shipment, and billing record for receivables, and the contract, purchase order, receiving report and acceptance for payables. Reversing the process traces a consolidated transaction to its origins, such as systems identification and outputs and points of manual input.

Auditors must be able to trace your Accounts Receivable and Accounts Payable transactions all the way to the originating documents. They must also be able to verify from those documents that amounts recorded on the financial statements are based on factual information, that adjustments made to that information are made using appropriate accounting practices, and that proper authorization exists at each level of the transaction.

Systems analysis may be accomplished using resources from outside of your entity. The Defense Information Systems Agency (DISA) is one source. Another is the Defense Finance and Accounting Service (DFAS). Systems are analyzed to ensure that they are compatible with the future plans of the Department, and that they apply adequate controls for transaction authorization and separation of duties. They are also analyzed for their ability to provide meaningful financial information in a timely manner. This leads to the second component of the Discovery and Correction Phase, correction.

Discovery and Correction (cont.)

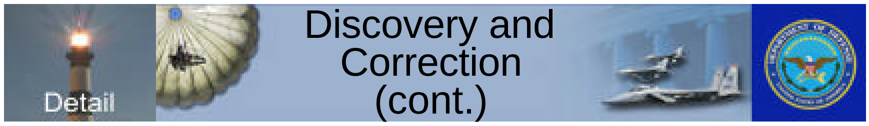
Correction requires DoD entities to implement solutions within the milestone dates prescribed, resulting in a resolution of the identified deficiency.

- **Identify any new deficiencies**
- **Modify plans to include any additions**
- **Requests for extension of suspense dates should include a plan for getting back on track to meet the next original milestone date**

Correction requires you to implement solutions within the milestone dates prescribed, resulting in a resolution of the identified deficiency. Correction is a multi-faceted and incremental process. All corrective action steps are not expected to be completed on the same date. Management personnel and audit committees closely monitor progress to ensure that actions taken achieve the intended results in the time allotted.

As corrections are ongoing, it is anticipated that new deficiencies may be identified. As this occurs, activities coordinate with their OUSD(C) POC to modify plans to include any such additions. Requests for extension of suspense dates should include actions taken to date, reason for date slippage, new proposed completion date, and a plan for getting back on track to meet the next original milestone date.

Let's consider these requirements.



Correction Requirements

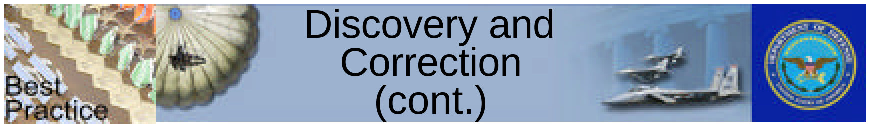
- **On time and incremental**
- **Resolve discrepancies**
- **Monitor progress and coordinate**
- **Extensions**

Corrective action plans must contain milestones and goals that are clearly measurable. Plans are incremental to allow for actions that may involve more than one entity. You must assign tasks to responsible individuals in accordance with the corrective action plans and then monitor progress. Individuals are held accountable for the accomplishment of their assigned tasks using the Balanced Scorecard approach.

As with many projects, problems may be encountered that require additional resources or time. You may reassign resources or request assistance from outside sources. Identified problems may require action from other entities prior to correction of the original discrepancy. In such cases, you may be required to re-organize actions that are not dependent upon the delayed processes, to allow for the continuation of corrections.

As other entities may depend on the resolution of your original deficiency, it is important that your agency coordinates with your OUSD(C) POC. Your POC works with you to identify resource requirements, coordinate schedules, and modify interim milestones. You must have a plan for meeting the next original milestone.

Let's examine some practices used by others.



Discovery and Correction (cont.)

Best Practices

- **Hold regular progress reviews**
- **Know your deficiencies**
- **Document responsibilities**
- **Partnership with DFAS, Defense Agencies, and Components**
- **Use available assistance**

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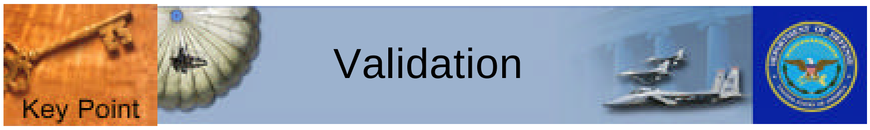
One best practice used in some organizations during the Discovery and Correction Phases is to have regular reviews to check on progress. As part of the monitoring process, reviews identify resource requirements that may not have been anticipated in the corrective action plans. Reviews should have clear agendas and require status reports by participants.

The best organizations know their deficiencies and assess their operations regularly. A recent practice within the Department is to brief mid-year and end-of-year financial statements to the DoD Comptroller. According to the Government Accountability Office (GAO) and the DoD OIG, the practice of preparing and explaining interim financial statements has improved the reliability of reported information through more timely discovery and correction of numerous recording and reporting errors. Correction can only begin from a position of knowledge.

You must document responsibilities and ensure that you have clearly communicated who must perform the actions, what must be done, when it should be completed, and the expected results of the actions. Successful organizations do not attempt to solve problems outside of their areas of expertise. DFAS can be an invaluable source of assistance because it is familiar with audit requirements and has passed more than one financial statements audit. DFAS is knowledgeable of financial reporting and documentation requirements, financial systems and their capabilities, and the trends in financial management. They can provide assistance in the analysis of your financial transactions and balances, and can explain unusual transactions that affect your financial statements. Audit agencies can also provide assistance with analysis and historical audit records, and other agencies, such as DISA, can provide specialized assistance in their areas of expertise.

Let’s discuss the Validation Phase.



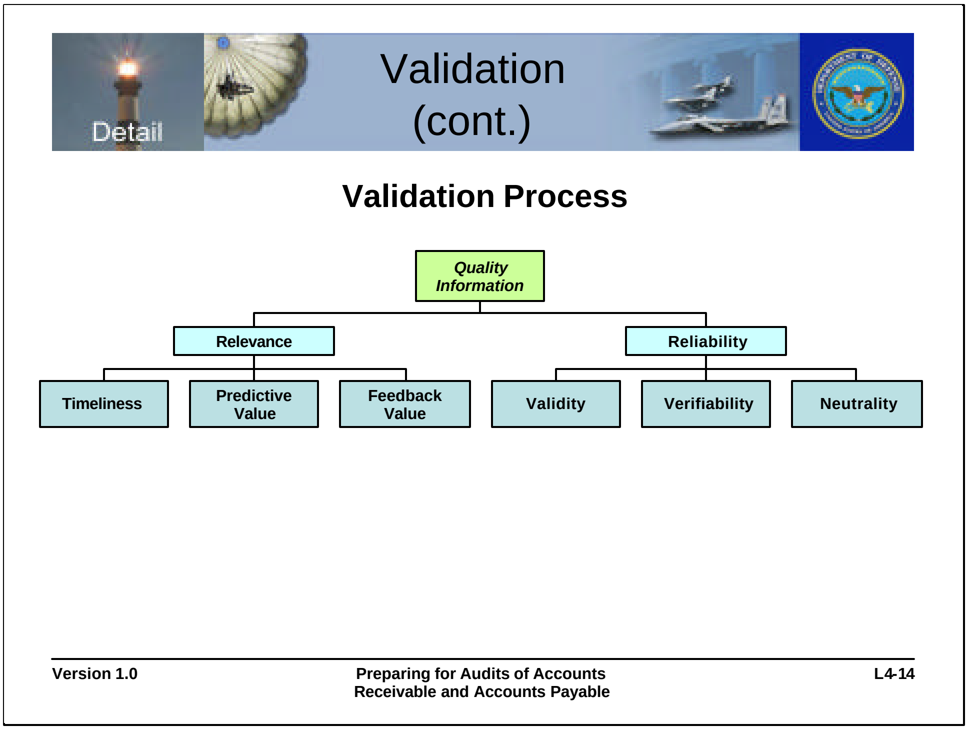
Validation Phase

Management validates financial information after corrective actions are completed.

Why	How
Implement 1008, enhance credibility of assertions, validate corrections.	Management validates that processes are documented, controls and systems are identified, and supporting documentation is available.

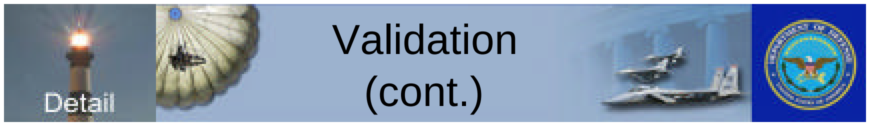
The purpose of the Validation Phase is to validate the effectiveness of the corrective actions. Validation determines whether transaction information and sufficient controls are available to support your management's assertion that Accounts Receivable or Accounts Payable lines are ready for audit and supporting documentation is available.

A validation is a limited scope evaluation or review to determine whether previously identified deficiencies in an entity's financial statements or line items have been satisfactorily remedied. This review is the responsibility of management and may be performed by management, internal auditors, or a contractor, under the supervision of management. The scope of specific procedures required for each validation is also the responsibility of management and determined in the context of the materiality of each issue or action taken.



The validation process is primarily for management to determine whether a particular statement or line is ready for an assessment or audit by the DoD OIG. To be audit-ready, information provided in the statement or line must be both relevant and reliable. Relevance is related to the usefulness of the information, such as its timeliness, predictive value, or feedback value. Reliability relates to the accuracy of the information. To be reliable, the information must be valid, verifiable, and unbiased or neutral.

Let's discuss the actions required in this phase.



Assertion Package Organization and Review Criteria

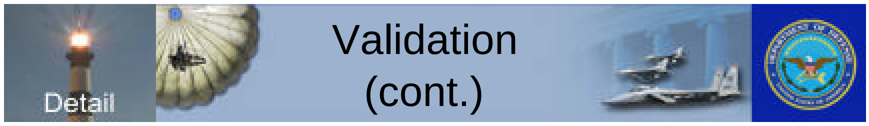
TAB	TOPIC	Checklist Step
1	Process Cycle Memos and Flow Charts	1
2	GL Transaction Detail/Support	2
3	Evidential Matter	3
4	Validation Summary (Management Assertion Letter, Completed Assertion Checklist, and Validation Work Products such as completed GAO Checklists, etc)	4
5	Status of FIP Corrective Actions	5
6	Summary of Corrective Actions Taken	6
7	Organization Charts/Contact Lists	7
8	FISCAM and SAS 70/88 Audit Date and POCs	8
9	FISCAM and SAS 70/88 Audit Results	9
10	Hardware, Software, and Interfaces	10
11	Type of Data Produced	11
12	Telecom/Network Information	12
13	Certifications/Accreditations	13
14	System/End User Locations	14
15	Location of Systems Documentation	15
16	Data Type/Summary of Transactions (Number, Type, Dollar Value)	16
17	List of Authorized Users	17
18	List of On-Going or Planned Reviews	18

During the Validation Phase, a validation of the resolution of the identified deficiencies is performed. These validations are performed at the request and under the oversight of management. Audit committees within your organization should be actively engaged in overseeing the progress of the validation process.

At this time, management completes a checklist that is required for the assertion package. The checklist includes steps for documenting the processes, identifying the controls and systems, and ensuring that the supporting documentation is available. This checklist and accompanying assertion information is used later during the Assessment and Audit Phases.

Notice that this checklist begins with the topic Process Cycle Memos and Flow Charts. To use the checklist, you must read the accompanying instructions that provide a full description of what is required to fulfill the checklist item.

Let’s examine the first item to demonstrate the use of this validation tool.



Validation (cont.)

Requirements for Checklist Item 1, Process Cycle Memos and Flow Charts:

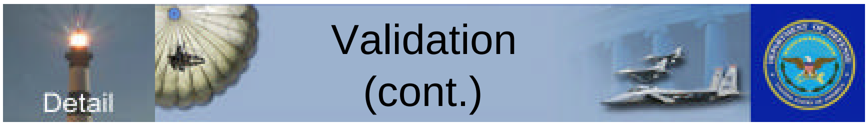
- **Identify and document the procedures, processes, and control points for deriving the balances**
- **Include the systems that are used and the flow of data from field level/installation to departmental level**
- **Identify all systems that have detail that make up the balances**

For the first item on the checklist, Process Cycle Memos and Flow Charts, identify and document the procedures, processes, and control points for deriving the balance or balances being asserted. Include the systems that are used and show the flow of data from the field level or installation to the departmental level.

This can be done in a cycle memorandum or flow chart format. Having this information prepared in advance is a great tool for you to refer to during the assessment and audit. And since this information is also used by the auditors as part of the audit, you will be prepared for them. Be sure to identify all the systems that have detail making up the balances being asserted as ready for audit, such as the Standard Operations and Maintenance Army Research and Development System (SOMARDS), Mechanization of Contract Administration Services (MOCAS), and Computerized Accounts Payable System (CAPS).

Earlier we covered the need to identify and document the procedures, processes, and controls within your entity. This process began in the Discovery and Correction Phase while you were working on the identification of problems and planning corrective actions. It continues and is completed in the Validation Phase. The instructions also include the criteria used to evaluate whether or not the required action was satisfactorily completed.

Let’s look at these criteria.



Validation (cont.)

Evaluation Criteria for Process Cycle Memos and Flow Charts

- **Accurately describe the regulations followed for the process**
- **Document procedures utilized**
- **Document key control techniques**
- **Identify systems used at the departmental level**
- **Include the management control objectives and risk assessments**

GAO/PCIE Financial Audit Manual (FAM): http://www.gao.gov

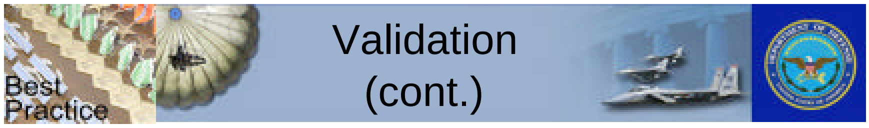
The evaluation criteria for processing cycle memos and flow charts states that a flow chart is required for each major process, and a cycle/process memorandum should be provided to:

- accurately describe the regulations followed for the process
- document procedures utilized
- document key control techniques
- identify systems used at the departmental level
- include the management control objectives and risk assessments.

Control techniques/activities are those activities that work to ensure that resources are used consistent with laws, regulations, and policies; are safeguarded against waste, loss, and misuse; and reliable data is obtained, maintained, and disclosed in reports. Examples include passwords, physical security, the separation of duties, and adequate supervision.

You should review the flow charts, cycle memorandum, and supporting documents for reasonableness and completeness for each process listed. The Government Accountability Office/President’s Council on Integrity and Efficiency Financial Audit Manual (GAO/PCIE FAM) Section 390.04, Cycle Memorandum and Flowchart, describes a cycle memorandum.

Let’s consider a few helpful practices.



Validation (cont.)

Helpful Practices in the Validation Phase

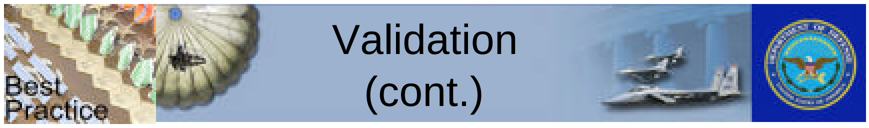
- **Think like an auditor**
- **Have a good method for organizing documentation**
- **Establish clear audit trails and keep a copy of the databases**

There are helpful practices to assist you during the validation process. For starters, you must think like an auditor. This includes the use of audit checklists, references, and tools that an auditor would use to assess the information supplied. Procedures used by auditors rarely call for complicated calculations or an in-depth analysis. Audit opinions are based on solid research of the entity's policies, practices, and procedures, and the resultant financial information reported.

To ensure that others reach the same conclusions with the same data set and validation methods, it is necessary to have a good method for organizing the documentation. Organizations that obtain favorable audit opinions have established organized methods for their documents that have clear audit trails.

It is a good idea to keep a copy of the databases used in your analysis of financial information because conclusions drawn using a particular set of data may not be valid when the data changes during the next accounting cycle, though the procedures for gathering that data should not change from one period to the next.

Let's discuss other helpful practices.



Validation (cont.)

Helpful Practices in the Validation Phase (cont.)

- **Ensure top management involvement and establish an audit committee or audit interest group**
- **Have good report writers**

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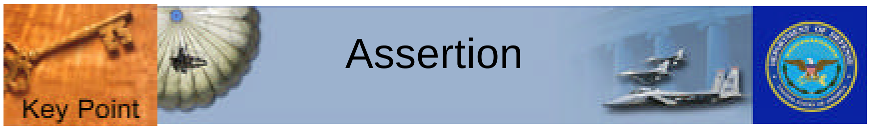
Top management involvement is critical, and having an audit committee or audit interest group ensures that those personnel who must answer audit inquiries are involved in the process. By their involvement, top management emphasizes the importance of the effort.

Remember that top management may not have time to review detailed technical data. You must have good report writers to summarize the data presented by technicians and analysts.

Let’s look at the Assertion Phase.



Assertion

Assertion Phase

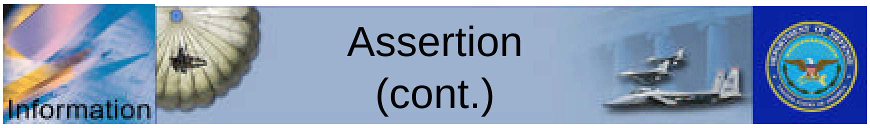
Management affirms to DoD OIG the reliability of the financial information.

Why	How
Communicate to DoD OIG & auditors the reliability of financial information.	Assertion letter to DoD OIG, checklist, and results of validation and reports; engagement letter and management representative letter, if used; memo to DoD OIG, copy to OUSD(C) RPS; ESC approval required for assessment or audit

The purpose of the Assertion Phase is to notify the DoD OIG that validation of corrected deficiencies has been completed and that your Accounts Payable or Accounts Receivable line items are ready for audit.

During the Assertion Phase, management prepares an assertion memorandum stating audit readiness and provides a package of accompanying documentation to support the position of audit readiness.

Let’s learn more about this phase.



Assertion (cont.)

Assertion Package

- **Management Assertion Letter**
- **Summary of the validation work performed**
- **Assertion checklist completed during the Validation Phase**

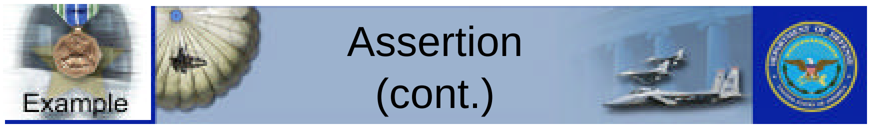
The assertion package is submitted to the DoD OIG, with a copy furnished to the OUSD(C) POC who forwards it to the RPS.

The assertion package contains:

- management assertion letter
- summary of the validation work performed that contains an explanation of actions taken by management to resolve deficiencies, and reports resulting from validation
- assertion checklist that was completed during the Validation Phase.

If the entity prepares an engagement letter or a management representation letter for the DoD OIG, subsequent representation letters should reflect management's assertions in them.

Let's look at each of these documents.



Example of the Management Assertion Letter

Organization name and address

Office symbol

Date stamp

Memorandum For (Organization Comptroller)

Subject: Management Assertion for (Named fund)

We are asserting that (Named fund) is auditable and we have completed corrective actions on material deficiencies for the (Named fund) line item on the balance sheet. (Named fund) is fairly presented in accordance with generally accepted accounting principles and is ready for audit. We are providing the completed assertion checklist information in the packet supporting our preparedness.

We completed the actions to correct the known material deficiencies as articulated in (source document). The specific actions taken to correct the material deficiencies can be found in (file name and location) of the assertion packet. Additional actions were completed to ensure adequate controls are in place to meet auditor documentation requirements and we received assurances of auditability from (source of assurance).

Sufficient audit-ready evidential matter is available to support the transactions that

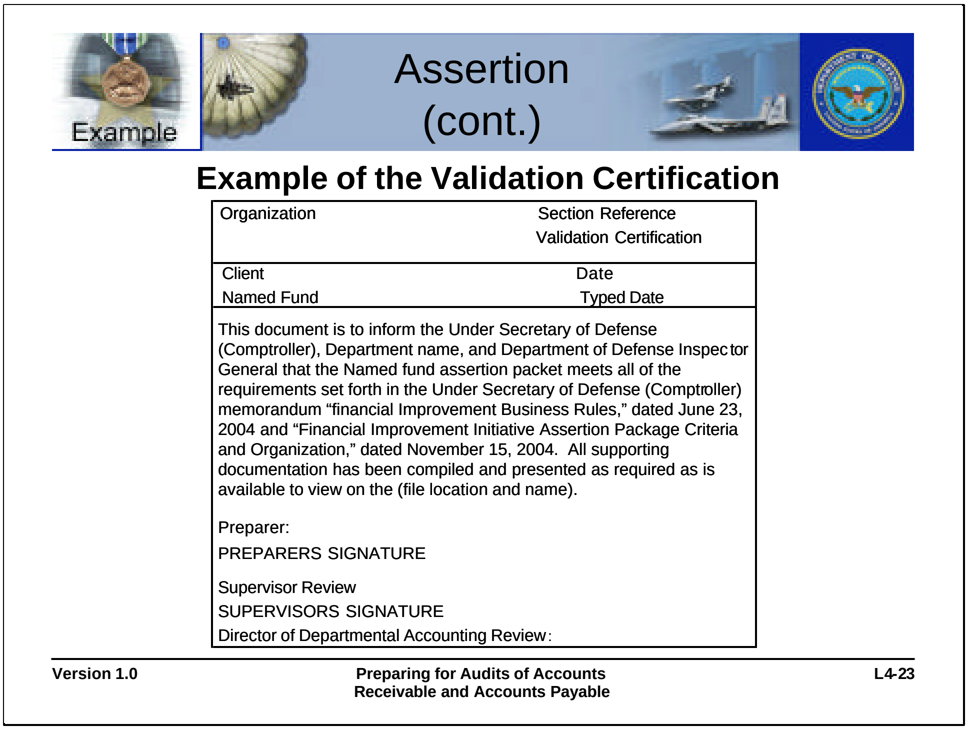
In this example of a management assertion letter, the organization is asserting that the named fund is auditable and that material deficiencies concerning that line item have been corrected. The assertion also states that the line item is fairly presented in accordance with Generally Accepted Accounting Principles (GAAP) and is ready for audit.

It then states the items included in the assertion packet that support the assertion.

The assertion letter contains the required assurance that sufficient audit-ready evidential matter is available to support the transactions that constitute the named fund, and the assurance that sufficient knowledgeable staff is available to support audit requests during audit fieldwork.

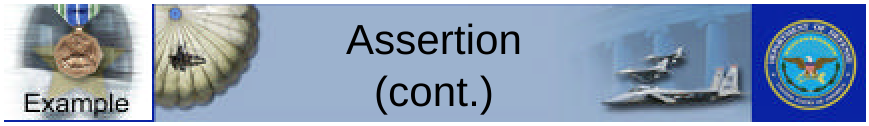
The next item is the validation information that includes the Validation Certification and the Validation Summary.

Let’s take a look at these documents.



In this example of the Validation Certification, the preparer, reviewers, and other members of management annotate with their signatures, that the named fund assertion packet meets all of the requirements set forth in the OUSD(C) memorandum concerning the Financial Improvement Initiative Business Rules and the memorandum subject, Assertion Package Criteria and Organization. They assert that all supporting documentation has been completed and presented as required, and is available to view at a specific file location.

Let’s look at the Validation Summary.



Example of the Validation Summary

Organization | Executive Summary – Fund Name Assertion Packet

Client	Date
Fund Name	November 30, 2004

Organization Name is asserting that the Fund Name and specific line item is ready for audit and balances reported in the quarterly and year-end financial statements are fairly presented in accordance with generally accepted accounting principles. Over the past five years the Organization has implemented several initiatives to improve the accountability over the execution and reporting of Fund name. These initiatives improved controls, increased the efficiency and timeliness of recording undistributed disbursements and collections in accounting systems, improved documentation, and reduced risk in the financial reporting process. These actions have put the organization in a position that with alternative auditing procedures the Fund name Balance Sheet line item ($xx.x billion) is ready for an audit.

Composition of Fund name

The organization receives the majority of funds in the form of direct appropriations ($xxx.x billion), as passed by Congress in the Annual Appropriation Acts passed by Congress. These are apportioned by the Office of Management and Budget (OMB), and recorded on the basis of the U. S. Treasury issuing a Warrant to the Organization. The funding business rules impacting Fund name have been auditable for a number of years. The organization's Fund name is decremented, or supplemented by reimbursable activity ($xx.x billion), by the recording of disbursements and collections at the U. S. Treasury. Organization has implemented several improvements since FY 2000 to ensure the timely recording of disbursements and collections (Net Outlays $xxx.x billion) and to improve documentation. These actions lead the Organization to consider the Fund name to be considered auditable.

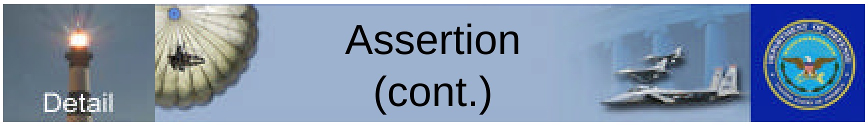
Improved Controls

The Organization Disbursing Network originally consisted of over XX disbursing activities processing over XXX fiscal stations. This structure caused enormous inconsistencies in business practices, large reconciliation issues, and minimal management control. To improve control, the network was consolidated into two

The Validation Summary outlines the corrective actions taken to improve accountability, controls, efficiency, timeliness, and documentation for the fund or balance being reported. It then states that the item is ready to be audited.

It may provide an overview of the fund prior to listing specific actions performed by the entity to prepare the fund or balance for audit. This is an area where accomplishments of the entity are highlighted, such as improvement in collection of Accounts Receivable and decreases in the incidence of Accounts Payable, requiring interest payments in accordance with the Prompt Payment Act. This is also an area where good report writing is essential.

Let's talk about the completed Assertion Checklist.



Assertion Checklist

Organization		Section III Assertion Packet Checklist
Prepared by	**Client**	**Date**
Typed name	Named fund or entity	November 30, 2004

√ Identify and document the procedures, processes, and control point for deriving the balances being asserted. Include the systems that are used and the flow of data from field level to departmental level.
RESPONSE: The procedures, processes, and control points are documented in the Process Analysis Document (PAD) and the Audit Folders. The PAD provides a high level overall flow of the Named Fund processes, information on the computer systems used, and process-level risks and controls. See Attachment A for a copy of the PAD. In addition, the Assertion Folders provide detailed documentation on each of the individual processes within the PAD to include listings of the incoming and outgoing reports, point of contacts, control points, risk areas, assumptions, and examples. See Attachment B for a list of all the Assertion Folders. Due to the volume, the folders are included in the assertion packet on the CD and on the file location and name."

In addition, Attachment C provides a methodology for audit planning. This provides suggestions for planning the named fund audit based on requirements set in the Governmental Accountability Office Financial Audit Manual and entity knowledge.

√ 1.Have all General Ledger transaction detail and supporting information from feeder systems available for all the transactions that make up the balance being asserted. Ensure the total of the detail equals the balance of the line item. This includes all accounting adjustments that have an effect on the ending balance of a line item reported on the financial statements
RESPONSE: Attachment D provides a list of all the transaction files, the POC, the location of ".

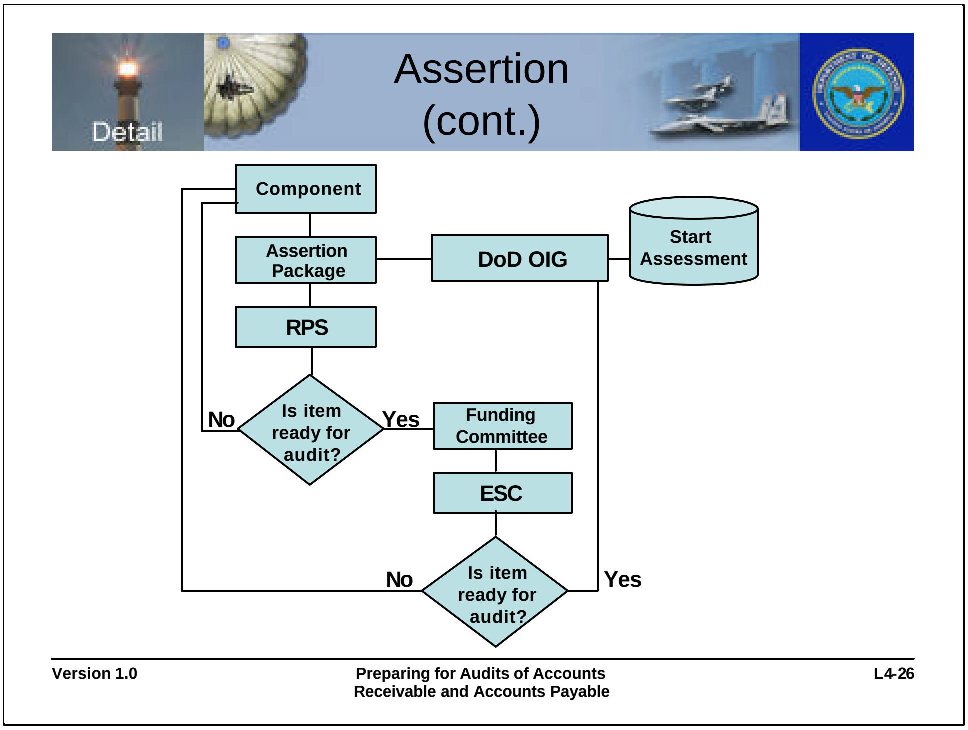
The completed Assertion Checklist provides a description of each topic and the entity's response to the requirements for its validation.

Notice in the first paragraph that the entity is required to identify and document the procedures, processes, and control points for deriving the balances being asserted. The corresponding response states the specific document name and location where the procedures, processes, and controls are documented.

The assertion process should include the specific system relationships between the line being asserted and all financial management systems and associated feeder systems.

For new systems that may not have previously identified problems, there is a requirement to include the Chief Financial Officers (CFO) Act fourteen point checklist for new systems or for each system in the assertion.

Let's discuss the distribution of and action taken on these documents.



The Component simultaneously submits the Assertion Package to the RPS and the DoD OIG. The DoD OIG are non-voting members of the RPS and the ESC and provide valuable input into the review of the assertion packages to include assessment and audit cost estimates.

If the RPS determines that the Assertion Package is audit-ready, it is submitted to the Funding Committee. The Funding Committee reviews the recommendations of the RPS for funding issues. The assertion package is then forwarded to the ESC along with the RPS prioritized recommendations concerning assessment and audit schedules.

The ESC, with the Funding Committees recommendation, reviews the Assertion Package for audit readiness. If it is audit-ready, the package is forwarded to the DoD OIG for audit. Once the DoD OIG receives the approved package from the ESC, they begin the assessment.

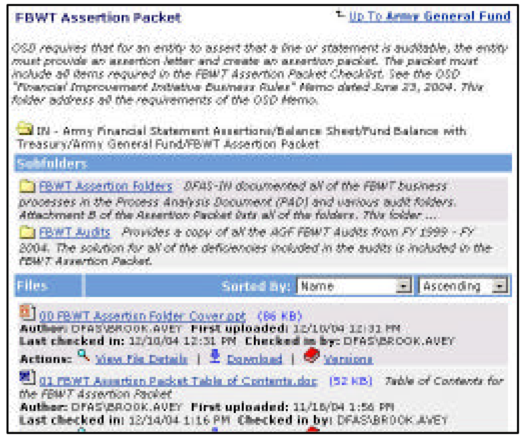
If the RPS or ESC makes a determination that the Assertion Package is not audit-ready, it is returned to the submitting Component.

Let's look at an example of a good assertion documenting process.

Assertion (cont.)

Best Practice

- **Develop a method of organized folders**
- **Army financial statement assertions on DFAS ePortal**



To save time and audit cost, it is important to develop a method of organizing folders so that all assertion data can be retrieved and reviewed quickly and efficiently.

An example of an Army method for organizing folders for Financial Statement Assertions, is shown on the DFAS ePortal. Here you will find folders that are set up for each of the affected financial statements. And, within each statement folder, subfolders can be found for various line items, such as Accounts Payable, Cash, and Fund Balance with Treasury (FBWT).

Each line item is further subdivided by fund or other applicable division. In the case of FBWT, it is subdivided into folders for the Army General Fund and the Army Working Capital Fund. Once the fund is selected, a subfolder containing the FBWT assertion packet information can be opened.

Subfolders in this area are divided into assertion or audit files. Assertion files include a table of contents file and numbered files that are labeled by section and title. Audit files are labeled by agency and title or report number of the audit reports.

Let's examine the Assessment Phase.

Assessment Phase

The DoD OIG reviews financial information to determine if it is ready for audit.

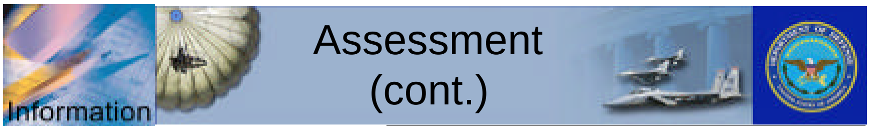
Why	How
Implements 1008, allows remediation, attests to management assertion, plans audit, reduces risk of unknowns to auditor, auditors' introduction to organization	DoD OIG oversight of IPAs or DoD OIG in-house assessments

The purpose of the Assessment Phase is to determine the reliability of the line or statement that the entity asserted as being ready for audit.

This assessment is substantially less than an audit, but should be sufficient enough to verify that the corrective actions implemented during the Discovery and Correction Phase of the financial improvement initiative were successful.

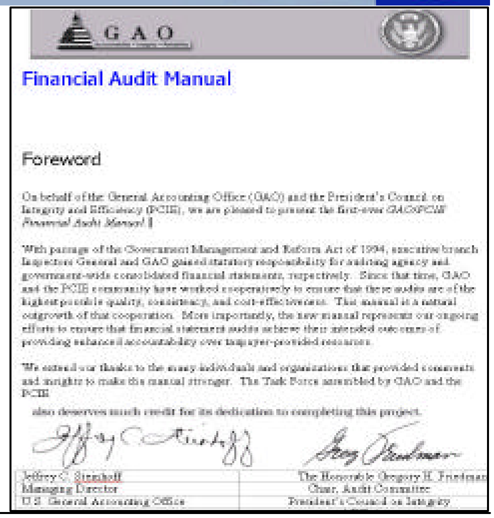
Assessment is generally done first if a statement has never been audited. Assessment could also occur when the DoD OIG believes circumstances may exist that would cause the entity to obtain an opinion other than unqualified. An example of such a situation is a system of internal control allowing for the disbursement of funds without proper certification. In this case, the DoD OIG would determine that an assessment is necessary to ensure reliability as required per Section 1008, of the National Defense Authorization Act. During the Assessment Phase, an entity may perform a remedy in the event a deficiency is identified that would prevent an unqualified opinion.

Let's continue with the Assessment Phase.



Assessment (cont.)

The scope of the assessment consists of accomplishing the audit steps outlined in the Planning Phase and Internal Control Phase of the audit manual.



GAO

Financial Audit Manual

Foreword

On behalf of the General Accounting Office (GAO) and the President's Council on Integrity and Efficiency (PCIE), we are pleased to present the first-ever GAO/PCIE *Financial Audit Manual*.

With passage of the Government Management and Reform Act of 1994, executive branch Inspectors General and GAO gained statutory responsibility for auditing agency and government-wide consolidated financial statements, respectively. Since that time, GAO and the PCIE community have worked cooperatively to ensure that these audits are of the highest possible quality, consistency, and cost-effectiveness. This manual is a natural outgrowth of that cooperation. More importantly, the new manual represents our ongoing efforts to ensure that financial statement audits achieve their intended outcomes of providing enhanced accountability over taxpayer-provided resources.

We extend our thanks to the many individuals and organizations that provided comments and insights to make this manual stronger. The Task Force assembled by GAO and the PCIE

also deserves much credit for its dedication to completing this project.

Jeffrey C. Steinhoff	The Honorable Gregory H. Friedman
Managing Director	Chair, Audit Committee
U.S. General Accounting Office	President's Council on Integrity

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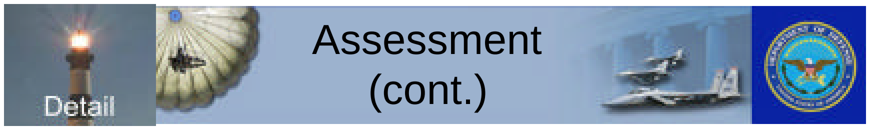
The assessment is performed by the DoD OIG, or by an independent public accountant contracted to perform work for the DoD OIG, after the ESC has approved the assessment. The scope of the assessment is determined in accordance with the FAM, and consists of accomplishing the audit steps outlined in the Planning Phase and Internal Control Phase of the audit manual. The assessment process determines whether the entity can likely achieve an unqualified audit opinion. If it is determined that circumstances or problems exist that preclude an unqualified opinion, a report is written to management that describes what has prevented the auditor from obtaining sufficient, reliable, and competent information. The report recommends to management what needs to be accomplished to remedy the problems.

The Assessment Phase is used as part of the DoD OIG's audit strategy to reduce risks of the unknown and introduce new auditors to the entity's processes. Progress is reviewed and monitored by management and your entity's audit committee through regularly scheduled interim progress reports. Management informs its OUSD(C) POC of any new deficiencies identified. There is continued communication, both written and oral, as the assessment progresses. Management should take actions to correct problems identified during the assessment. The DoD OIG recommends when it is appropriate to move forward with a formal audit.

Let's look at a few of the audit steps outlined in the Planning Phase and Internal Control Phase of the audit manual.



FAM, Planning Phase

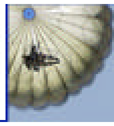
200	**PLANNING PHASE**
210	Overview
220	Understand the Entity's Operations
225	Perform Preliminary Analytical Procedures
230	Determine Planning, Design, and Test Materiality
235	Identify Significant Line Items, Accounts, Assertions, and RSSI
240	Identify Significant Cycles, Accounting Applications, and Financial Management Systems
245	Identify Significant Provisions of Laws and Regulations
250	Identify Relevant Budget Restrictions
260	Identify Risk Factors
270	Determine Likelihood of Effective Information System Controls

The Planning Phase requires auditors to gain an understanding of the entity's operations, perform preliminary analytical procedures, and determine planning, design, and test materiality. The FAM suggests a guideline for overall materiality of 3 percent of the materiality base. The materiality base the DoD OIG currently uses is the Total Assets minus the Intra-governmental assets. The guideline for design, test, or account materiality is 1 percent of the materiality base. What this means is that total misstatements on a financial statement cannot exceed overall materiality of 3 percent, while total misstatements on a particular line such as Accounts Receivable cannot exceed 1 percent.

An immaterial omission on Accounts Receivable or Accounts Payable, combined with omissions or misstatements from other accounts on the Balance Sheet could be material in total. If auditors cannot determine the amount of omissions and misstatements, then they have to disclaim an opinion because the amount of misstatement is unknown.

Auditors must also identify significant line items, accounts, and assertions. In gaining an understanding of the entity's operations, auditors identify significant cycles, accounting applications, and financial management systems. They also familiarize themselves with the provisions of laws, regulations, and budget restrictions. Auditors evaluate risk factors and determine the likelihood of effective information systems controls and then identify relevant operations controls to evaluate and test.

Let's consider the identification of significant cycles, accounting applications, and financial management systems listed in the FAM.



Assessment (cont.)

FAM, Planning Phase (cont.)

Planning Phase

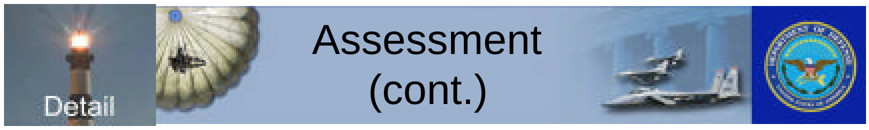
240 - IDENTIFY SIGNIFICANT CYCLES, ACCOUNTING APPLICATIONS, AND FINANCIAL MANAGEMENT SYSTEMS

.01 In the internal control phase, the auditor evaluates controls for each significant cycle and accounting application and determines whether significant financial management systems substantially comply with federal financial management systems requirements, federal accounting standards, and the SGL at the transaction level. A cycle or an accounting application should be considered significant if it processes an amount of transactions in excess of design materiality or if it supports a significant account balance in the financial statements or significant RSSI. A financial management system generally consists of one or more accounting applications. If one or more of the accounting applications making up a financial management system are considered significant, then that financial management system generally should be considered significant for determining whether the system substantially complies with FFMIA requirements. The auditor may identify other cycles, accounting applications, or financial management systems as significant based on qualitative considerations. For example, financial management systems covered by FFMIA include not only systems involved in processing financial transactions and preparing financial statements, but also systems supporting financial planning, management reporting, or budgeting activities, systems accumulating and reporting cost information, and the financial portion of mixed systems, such as benefit payment, logistics, personnel, and acquisition systems.

.02 The entity's accounting system may be viewed as consisting of logical groupings of related transactions and activities, or accounting applications.

The FAM describes the identification of significant cycles, accounting applications, and financial management systems requirements by providing an overview of the auditors' duties as they relate to this item. It defines significance as it relates to each item and how the items are affected by both financial and non-financial systems.

Let's talk about the Internal Control Phase.



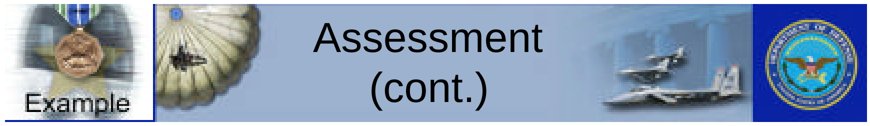
Assessment (cont.)

FAM, Internal Control Phase

300	**INTERNAL CONTROL PHASE**
310	Overview
320	Understand Information Systems
330	Identify Control Objectives
340	Identify and Understand Relevant Control Activities
350	Determine the Nature, Timing, and Extent of Control Tests and of Tests for Systems' Compliance with FFMIA Requirements
360	Perform Nonsampling Control Tests and Tests for Systems' Compliance with FFMIA Requirements
370	Assess Controls on a Preliminary Basis
380	Other Considerations
390	Documentation

The Internal Control Phase requires auditors to gain an understanding of the entity's information systems, control objectives, and relevant control activities. They must determine the nature, timing, and extent of control tests and of tests for systems compliance with legal requirements. To determine the testing required, auditors perform control and compliance testing on a preliminary basis.

Let's take a closer look at identifying and understanding relevant control activities.



FAM, Internal Control Phase (cont.)

Internal Control Phase

340 - IDENTIFY AND UNDERSTAND RELEVANT CONTROL ACTIVITIES

.01 For each control objective, based on discussions with entity personnel, the auditor should identify the control activities designed and implemented to achieve the specific control objective.[1] Such controls may be recorded in the auditor's informal notes and/or interview write-ups for use in the following procedure, but each control activity need not be formally documented on the SCE worksheet at this time. The auditor should first screen the activities to identify those that are effective and efficient to test. An IS auditor may assist the auditor in identifying and understanding IS controls.

BASIC UNDERSTANDING OF EFFECTIVENESS OF CONTROL ACTIVITIES

.02 The auditor should obtain a sufficient understanding of the identified control activities to determine whether they are likely to achieve the control objectives, assuming an effective control environment, risk assessment, communication, and monitoring, appropriate segregation of duties, and effective general controls. The purpose of this assumption is to identify any weaknesses in the specific control activities that should be corrected. When other internal control components are poor, there is inadequate segregation of duties, or poor general controls preclude the effectiveness of specific control activities that would otherwise be effective, the testing of such specific control activities may be limited to determining whether such controls are in place. To accomplish this, the auditor might (1) discuss the cycle and specific controls with management and then (2) perform walkthroughs by observing the controls in place or examining several items

FACTORS TO CONSIDER

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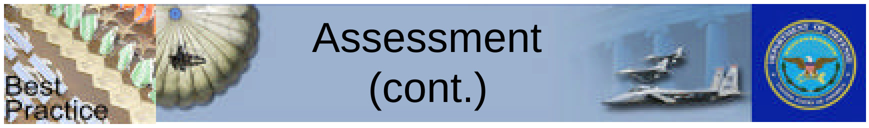
Relevant control activities are described as those that are designed to achieve the specific control objectives. The auditors first screen the activities to identify those activities that are effective and efficient to test, in an effort to obtain a sufficient understanding of the identified control activities. The auditors must determine whether they are likely to achieve the control objectives, assuming that there is an effective control environment, appropriate risk assessment, communications, monitoring, segregation of duties, and effective general controls.

The auditors identify any weaknesses in specific control activities that should be corrected. When internal control activities are poorly designed, there may be inadequate segregation of duties, or poor general controls which may prevent specific control activities from being effective. The testing of these control activities may be limited to determining whether they are in place.

Let’s examine a few practices that are particularly useful in the Assessment Phase.



Best Practices during the Assessment Phase

- **Know the audit process and the regulations driving it**
- **Have good training and awareness for all staff**
- **Change the mindset toward audits**
- **Know the auditors' checklist**
- **Staff resources to work with auditors**

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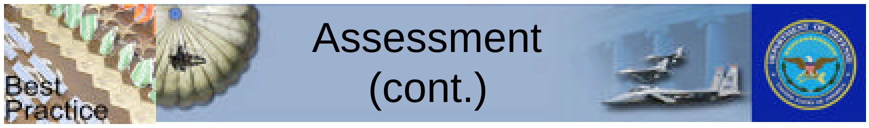
If you know the audit process and the regulations driving it, you can anticipate the auditors' requirements. It is important that good training and awareness for all staff is included in your assessment strategy. With adequate training on what is expected, you ensure that your people are ready for the audit.

You must lead a change in the mindset toward audits; they are not just for the financial community. You may set up a web site or have a newsletter. Frequent communication is necessary to convey expectations, goals, and direction.

When the auditors examine an entity's operations, you should know the auditors' checklist. You can then anticipate what is going to be needed and plan early to allow the audit to move quickly with less disruption to business operations.

Successful organizations ensure that they have adequate resources in place to assist in the audit effort. You must assign resources to work with auditors or hire contractors.

Let's continue with a few more practices.



Best Practices during the Assessment Phase (cont.)

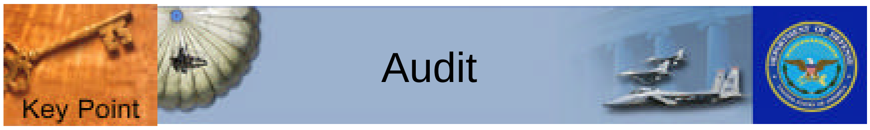
- **Have the right people in jobs**
- **Have document retrieval methods documented**
- **Have consistent practices**

Having the right people in jobs is critical to the audit effort. If not, the process slows down considerably. Auditors will ask the most available person questions concerning your entity's operations, controls, and procedures. You must ensure that the most available person is also the most knowledgeable person.

You must have document (paper and electronic) retrieval methods established and documented, especially for historical data. Ledgers containing all transactions should be ready and include all documentation and back-up matter. This matter may include purchase orders, invoices, receiving reports, and other essential documentation. This source documentation can be located in several different offices. It must be pulled together to support the financial records.

Auditors are looking for consistent practices that are within established guidelines.

Let's move on to the Audit Phase.



Audit Phase

The DoD OIG audits the organization's financial statements that management asserted were ready for audit and that passed the DoD OIG assessment.

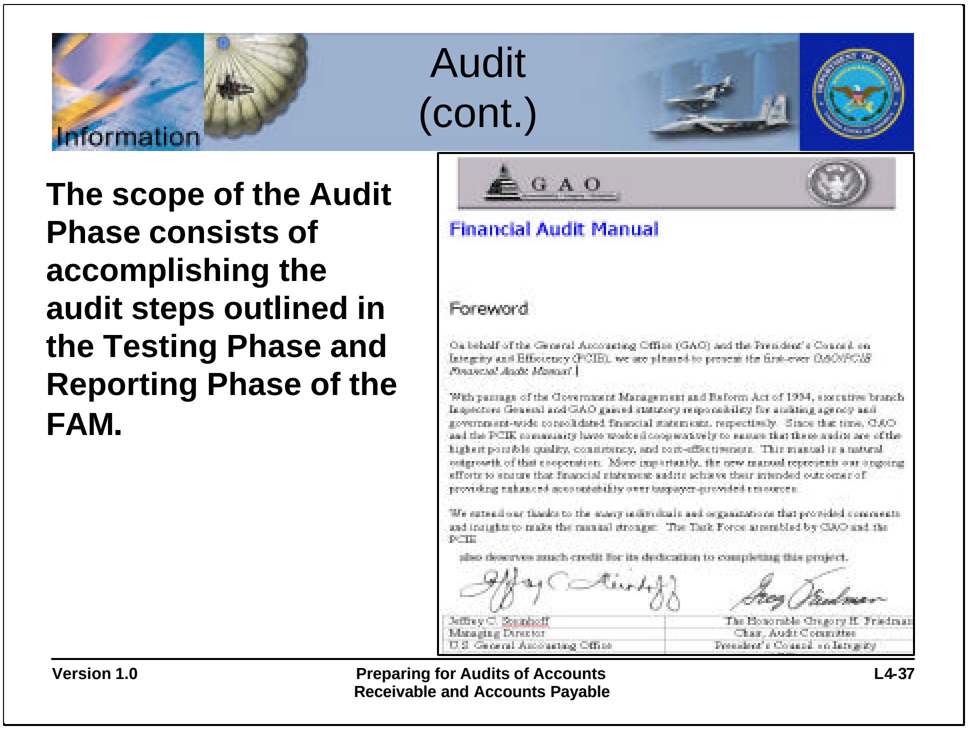
Why	How
Implement CFO Act, implement 1008, Presidents' Management Agenda.	Pass assessment, DoD OIG oversight of IPAs or DoD OIG in-house audits

The purpose of the Audit Phase is to obtain an auditor's opinion of the condition of an entity's financial statement or line.

The purpose of this phase is also to obtain an auditor's opinion of the fairness of the presentation of the information in the financial statements.

When a financial statement or portion thereof is asserted to be ready for audit and has passed assessment, or assessment has been waived, the DoD OIG determines the appropriate scope and nature for a financial audit and the associated reports.

Let's learn more about this phase.



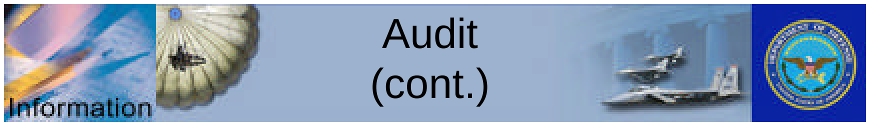
During the Audit Phase, the entity and its accounting records are audited to determine if the balances and related notes presented on its financial statements fairly represent the operations of the entity.

With the assistance of the DoD OIG, reporting entities prepare detailed engagement letters requesting audit services. The auditors then require any management representations made to date that concern the items to be included in the audit. DoD reporting entities prepare as many interim management representation letters as necessary to include any additional assertions required by the audit. They then prepare a final management representation letter.

Management personnel address deficiencies with a written plan for resolution, including projected resolution dates. The DoD OIG intervenes if necessary to end the audit and recommends a follow-up assessment, upon indication that the audit may not have a favorable outcome.

The scope of the Audit Phase consists of accomplishing the audit steps outlined in the Testing Phase and Reporting Phase of the FAM.

Let's look at a few of these steps.



Audit (cont.)

Testing Phase

- **Auditors consider the nature, timing, and extent of tests**
- **Tests must provide the greatest benefit for the least amount of time and resources**

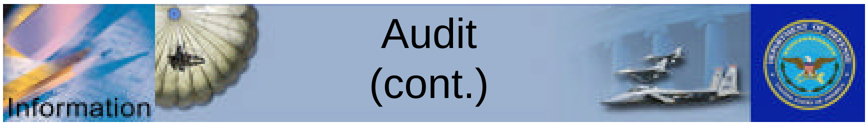
400	TESTING PHASE
410	Overview
420	Consider the Nature, Timing, and Extent of Tests
430	Design Efficient Tests
440	Perform Tests and Evaluate Results
450	Sampling Control Tests
460	Compliance Tests
470	Substantive Tests – Overview
475	Substantive Analytical Procedures
480	Substantive Detail Tests
490	Documentation

The Testing Phase consists of a consideration of the nature, timing, and extent of tests to be performed on the evidentiary matter associated with the audit. The auditors must design efficient tests that provide the greatest benefit for the least amount of time and resources. The auditors must then perform those tests and evaluate results. Several types of testing are available and are explained within the FAM.

The How to Manage Audit Evidential Matter course provides additional information concerning audit testing methods.

Once testing is completed, the auditors must document the results in order to ensure that adequate audit procedures have been accomplished.

Let's look at the requirement for performing tests and evaluating results.



Audit (cont.)

Testing Phase (cont.)

- **Tests should evaluate the results of each type of test separately**
- **Tests performed with the expectation of obtaining certain results may give other results**

Testing Phase

440 - PERFORM TESTS AND EVALUATE RESULTS

.01 The auditor should perform the planned tests and should evaluate the results of each type of test separately, without respect to whether the items were chosen as part of a multipurpose test. Guidance on performing and evaluating the results is presented for each type of test in the following sections

- Section 450 - Sampling control tests,
- Section 460 - Compliance tests, and
- Section 470 - Substantive tests.

.02 Sometimes, tests performed with the expectation of obtaining certain results give other results. When this happens, the auditor may wish to expand a sample to test additional items. Unless planned for in advance, this generally cannot be done simply, as discussed in paragraphs 450.17, 460.02, and 480.28; the auditor should consult with the Statistician in such cases.

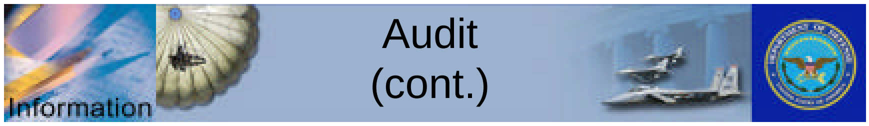
The FAM states that the auditors should perform the planned tests and should evaluate the results of each type of test separately, without respect to whether the items were chosen as part of a multipurpose test.

It states that sometimes, tests performed with the expectation of obtaining certain results give other results.

When this happens, the auditors may wish to expand a sample to test additional items.

Unless planned for in advance, this generally cannot be done simply and the auditors should consult with a statistician.

Let’s discuss the Reporting Phase.



Reporting Phase

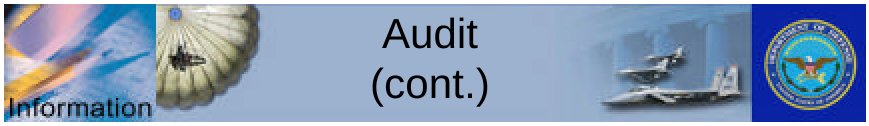
500	REPORTING PHASE
510	Overview
520	Perform Overall Analytical Procedures
530	Determine Adequacy of Audit Procedures and Audit Scope
540	Evaluate Misstatements
550	Conclude Other Audit Procedures • Inquiries of Attorneys • Subsequent Events • Management Representations • Related Party Transactions
560	Determine Conformity With Generally Accepted Accounting Principles
570	Determine Compliance With GAO/PCIE Financial Audit Manual
580	Draft Reports

The Reporting Phase requires the auditors to perform overall analytical procedures. This does not mean that all testing must be re-done, but that the results of all of the testing must be analyzed in order to formulate conclusions. The auditors must also determine the adequacy of audit procedures and the audit scope in the formulation of these conclusions.

Misstatements are evaluated for their severity. If material, they may affect the overall opinion of the auditors. Other audit procedures include inquiries of the attorneys who represent the entity. Auditors must determine whether there are any pending liabilities that were not adequately disclosed in the notes to the financial statements.

The auditors must determine whether the presentation of the financial statements is in conformity with GAAP and whether the entity is in compliance with the FAM. The auditors then draft reports on the financial statements, internal control, financial management systems, and compliance with laws and regulations. The reports are used during the discussion of audit findings during the exit conference, though most items will have already been addressed throughout the audit.

Let’s expand on these reports.



Audit (cont.)

Reporting Phase (cont.)

Auditors reports include conclusions on the:

- **Financial Statements**
- **Internal Control**
- **Compliance with laws, requirements, and standards**

Reporting Phase

580 - DRAFT REPORTS

.01 At the conclusion of the audit, the auditor finalizes the draft of the auditor's report(s), which includes the auditor's conclusions on

- the financial statements (see paragraphs 580.10-.31);
- internal control (see paragraphs 580.32-.61);
- whether the financial management systems substantially comply with the requirements of FFMIA: federal financial management systems requirements, federal accounting standards (GAAP), and the SGL at the transaction level (see paragraphs 580.62-.66); and
- compliance with laws and regulations (see paragraphs 580.67-.75);
- the MD&A (see requirements in SFFAS No. 15) and other information included in the Accountability Report (including RSSI) (see paragraphs 580.76-.81).

.02 The auditor's report should clearly identify the entity audited, the Accountability Report on which the auditor is reporting, and the period covered by the Accountability Report.

.03 The report should be dated as of the completion of fieldwork. If a subsequent event occurs after that time that requires disclosure in the report, the auditor should follow the guidance in AU 530 with respect to dating the

At the conclusion of the audit, the auditors finalize the reports. They include the auditors conclusions on the financial statements, internal control, and system compliance with requirements of the Federal Financial Management Improvement Act (FFMIA), federal financial management systems requirements, federal accounting standards, and the United States Government Standard General Ledger (USSGL) at the transaction level. They also include the auditors conclusions on the entity's compliance with laws and regulations.

The auditors report should clearly identify the entity audited, the accountability report on which the auditors are reporting, and the period covered by the accountability report. It should then be dated as of the completion of fieldwork.

Let's consider a few helpful practices.

Audit (cont.)

Best Practices during the Conduct of the Audit

- **Plan the entrance conference**
- **Maintain communications with POCs and employees**
- **Assign an audit liaison**
- **Monitor information consistently and keep track**

Various practices are particularly helpful during the conduct of an audit.

An audit should contain no surprises. Once you have engaged auditors, you must plan for the entrance conference. Ensure that adequate and knowledgeable staff is available, that adequate time is scheduled without interruption, and that a congenial atmosphere is maintained. Be familiar with the areas to be audited and know the procedures used to test those areas.

You must communicate audit requirements with your POCs and employees to ensure a smooth audit process. Knowledgeable personnel must be available to the auditors throughout the audit. You should assign an audit liaison. By having a proper escort, the auditors' questions are likely to be answered correctly, and there is less likelihood of delays in the conduct of the audit.

Information obtained in the audit process should be monitored, appropriately catalogued, and filed for immediate or later action.

Let's summarize what we've discussed in this lesson.

- **Overview**
- **Discovery and Correction**
- **Validation**
- **Assertion**
- **Assessment**
- **Audit**

In looking at the five-phase process used by the Department's leadership to prepare for a clean audit, you found that the Discovery and Correction Phase is intended to correct deficiencies and plan solutions to produce accurate data. The Validation Phase purpose is to validate the effectiveness of the corrective actions, and to determine if sufficient controls, transaction information, and supporting documentation are available to support management's assertion that the line or statement is ready for audit. In the Assertion Phase, your entity management notifies the DoD OIG that validation of corrected deficiencies has been completed and that a financial statement or line item is ready for audit.

In the Assessment Phase, the DoD OIG assesses the reliability of the line or statement which your entity asserted as being ready for audit. That assessment is generally done first if a statement has never been audited. In the Audit Phase auditors obtain an opinion of the fairness of the presentation of the information in your financial statements. You found that the DoD OIG determines the appropriate scope and nature for the financial audit and the associated audit reports.

The following slide lists references for additional information.

References

GAO/PCIE FAM: http://www.gao.gov

FFMIA:
http://www.dod.mil/comptroller/icenter/inforef/ffmia96.pdf

Questions

Before we proceed with the End-of-Course Review, do you have any questions on the material covered in this lesson?

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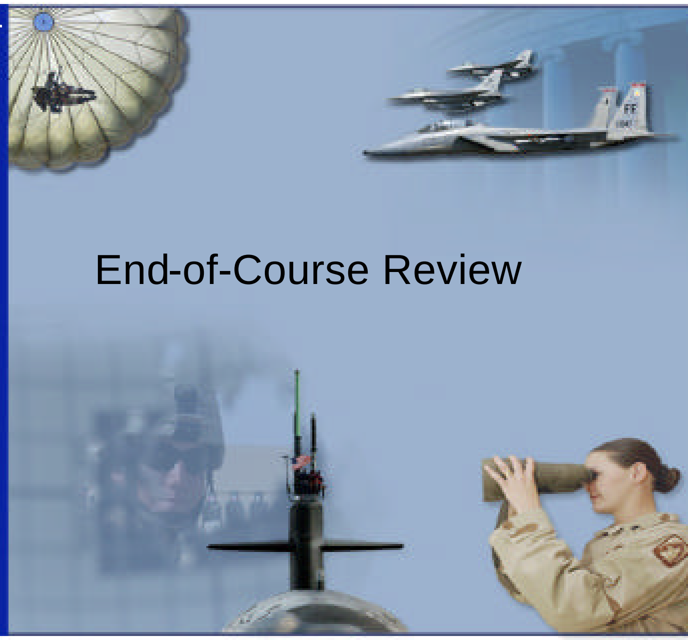
Preparing for Audits of Accounts Receivable and Accounts Payable



End-of-Course Review

Lesson 1, Overview of Receivables and Payables

- **Overview of Receivables and Payables**
- **Audit Terms**
- **Why Audit**
- **What Audits Determine**

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In Lesson 1, you learned that Accounts Receivable arise from claims to cash or other assets against another entity. You found that payables are amounts owed to the entity for goods or services received, and that they are recognized upon actual or constructive delivery of the good or service.

You became familiar with several terms such as reasonable assurance, materiality, various audit opinions, deficiencies, systemic weaknesses, and management assertions.

We discussed why audits are required by introducing the FFMIA, the FMFIA, the CFO Act, and the IG Act. We looked at auditing standards and the regulatory requirements for the reporting of financial information that are contained in the OMB guidance, TFM, and DoDFMR.

You found that audits provide a means of testing current data and reporting control procedures to validate whether or not those procedures would enable users of the financial data to rely on the underlying information that supports the reported financial data.

Lesson 2, Accounts Receivable

- **Receivables Recognition**
- **Debt Collection Process**
- **Receivables Reconciliation**
- **Intra-governmental Receivables**
- **Receivables Verification**

In Lesson 2, you learned that receivables are recognized at the time of transfer of the associated assets. In discussing debt collection processes, you explored the provisions of the DCIA and estimation of an Allowance for Uncollectible Accounts. We talked about the aging of receivables accounts and processes used for debt collection within the Department.

You found that Receivables Reconciliation involves several individuals and offices and that several reconciliation reports are required including the MDMR, MRR, and TROR.

You found that intra-governmental receivables are categorized through customer identification. We discussed the recording of collections of intra-governmental receivables and that intra-governmental receivables cannot be reduced by means of an allowance for doubtful accounts.

In Receivables Verification we discussed tools such as aging reports and the FAM. We also discussed some common procedures for account verification to include tests of transaction details, documentation of processes, and communication.

Lesson 3, Accounts Payable

- **Payables Recognition**
- **Budgetary Resources and Payable Authorizations**
- **Payables Reconciliation**
- **Intra-governmental Eliminations of Payable Balances**
- **Payables Verification**

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In Lesson 3, we discussed when payables are recognized and the sources of payable transactions. We looked at document handling procedures to include file maintenance and internal control techniques. We then discussed the provisions of the Prompt Payment Act to include the calculation of payment due dates and the requirement for interest payments on overdue payments to the public.

In discussing Budgetary Resources and Payable Authorizations we described how funding is distributed through the use of FADs. We also discussed common indicators of violations of the ADA.

We talked about Payables Reconciliation and about the duties and responsibilities for the reconciliation process.

You found that identification of intra-governmental payables allows for their elimination in the consolidated financial statements.

We examined the verification of payables and audit tools that are available to you, such as the FAM.

Lesson 4, The Assertion Process

- **Overview**
- **Discovery and Correction**
- **Validation**
- **Assertion**
- **Assessment**
- **Audit**

In the last lesson, we found that there are specific processes that are used to improve the reliability of your financial reporting. We focused on the five-phase process known as the Financial Improvement Initiative Business Rules.

In each of these phases, you have tasks to accomplish that are intended to identify problem areas, develop and implement solutions, and validate the effectiveness of those solutions. Upon completion of validation, you assert your readiness for audit with the submission of the assertion package which contains the results of the validation.

You found that during the assessment, the auditor plans the audit and assesses your internal controls. The audit phase consists of accomplishing the various testing necessary to determine if the financial statements and related notes of your entity are fairly presented.

Let's continue with the final examination.

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Appendix A. Glossary

This glossary should serve as a reference tool for DoD personnel who need an understanding of auditing terminology related to Accounts Receivable and Accounts Payable. It is not all-inclusive and reflects both acronyms and terms introduced throughout this course.

AAA	Army Audit Agency
ACO	Administrative Contracting Officer
ADA	Anti-Deficiency Act
AEP	Accrued Expenditures Paid
AEU	Accrued Expenditures Unpaid
ALC	Agency Location Code
ARO	Accounts Receivable Office
ARSSSR	Accounts Receivable Single Source Submission Report
AT&L	Acquisition, Technology, and Logistics
CAGE	Commercial and Government Entity
CAPS	Computerized Accounts Payable System (Army)
CDS	Contract Debt System
CFE	Chief Financial Executive
CFO	Chief Financial Officer
CFO Act	Chief Financial Officers Act
CNC	Currently Not Collectible
CONOPS	Concept of Operations
DCIA	Debt Collection Improvement Act
DCM	Debt and Claims Management Office
DD	Department of Defense (as in DD Form)

DDMS	Defense Debt Management System
DDRS	Defense Department Reporting System
DEBX	Database Exchange
DFAS	Defense Finance and Accounting Service
DFAS-CO	Defense Finance and Accounting Service, Columbus Center
DFAS-DE	Defense Finance and Accounting Service, Denver Center
DISA	Defense Information Systems Agency
DLTR	Demand Letter Tracking Report
DMO	Debt Management Office
DO	Disbursing Officer
DoD	Department of Defense
DoDD	Department of Defense Directive
DoDFMR	Department of Defense Financial Management Regulation
DoD OIG	Office of the Department of Defense, Inspector General
DoJ	Department of Justice
DWCF	Defense Working Capital Fund
EDI	Electronic Data Interchange
EFT	Electronic Funds Transfer
ESC	Executive Steering Committee
FACTS	Federal Agencies' Centralized Trial Balance System
FAD	Funding Authorization Document
FAM	Financial Audit Manual (of the GAO PCIE)
FASAB	Federal Accounting Standards Advisory Board
FBWT	Fund Balance with Treasury
FFMIA	Federal Financial Management Improvement Act

FMFIA	Federal Managers Financial Integrity Act
FMS	Financial Management Service
FY	Fiscal Year
GAAS	Generally Accepted Auditing Standards
GAAP	Generally Accepted Accounting Principles
GAGAS	Generally Accepted Government Auditing Standards
GAO	Government Accountability Office
GAO/PCIE FAM	Government Accountability Office/President's Council on Integrity and Efficiency Financial Audit Manual
GRS	General Records Schedule
GSA	General Services Administration
IG	Inspector General
IGTS	Intra-governmental Transaction System
IPAC	Intra-Governmental Payment and Collection System
MDA	The Management Discussion and Analysis is the section of the PAR that precedes the financial statements.
MDMR	Monthly Debt Management Report
MILSBILLS	Military Standard Billing System
MILSTRIP	Military Standard Requisitioning and Issue Procedure
MIPR	Military Interdepartmental Purchase Request
MOCAS	Mechanization of Contract Administration Services
MRR	Monthly Receivables Report
NARA	National Archives and Records Administration
NULO	Negative Unliquidated Obligation
ODC(P/B)	Office of the Deputy Comptroller, Program Budget
OM&S	Operating Materials and Supplies

OMB	Office of Management and Budget
OSD	Office of the Secretary of Defense
OUSD(C)	Office of the Under Secretary of Defense, Comptroller
PAD	Performance, Analysis, and Design
PAR	Performance Accountability Report
PBAS	Program Budget Accounting System
PCO	Procurement Contracting Officer
PMO	Program Management Office
POC	Point of Contact
PowerTrack	A U.S. bank system intended to eliminate surface freight bills for all DFAS customers
RPS	Review & Prioritization Subcommittee
SecDEF	Secretary of Defense
SF	Standard Form
SFFAS	Statement of Federal Financial Accounting Standard
SOMARDS	Standard Operations and Maintenance Army Research and Development System
SOP	Standard Operating Procedure
TFM	Treasury Financial Manual
TI	Treasury Index
TIN	Taxpayer Identification Number
TOP	The Treasury Offset Program compares the names and TINs of debtors with the names and TINs of recipients of federal payments to enable collection of debt.
TPA	Trading Partnership Agreement
TROR	Treasury Report on Receivables Due from the Public

U.S. or US	United States
UMD	Unmatched Disbursements
UOO	Undelivered Order Outstanding
USC	United States Code
USD(C)	Under Secretary of Defense, Comptroller
USDA	United States Department of Agriculture
USSGL	United States Government Standard General Ledger
USTRANSCOM	United States Transportation Command

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Appendix B. Excerpts from the Performance and Accountability Report (PAR)

The following are excerpts from the FY 2004 Performance and Accountability Report. Additional copies of the Note 5 and Note 12 are included in the back of the appendix and can be torn out if students wish to follow along during class.

Message from the Deputy Secretary of Defense

November 15, 2004

I am pleased to present the Department of Defense fiscal year 2004 Performance and Accountability Report.

The Department has made significant progress in transforming America's defense posture to enable decisive plans to address future security challenges. We have demonstrated our superior warfighting capabilities in Iraq and Afghanistan. The price of democracy is not cheap. We see continual pressures on the Department's resources in the years ahead. We will focus relentlessly on efficient and careful use of these resources as we continue fighting the global war on terror.

The Department has made improvements in its personnel management practices and we will continue to drive towards a performance-based rating of our workforce. The quality of life of our military members, who risk their lives for all of us to enjoy the freedoms of democracy, has been enhanced by upgrading facilities and advancing private-public partnerships in military housing. We have also seen efficiencies due to practicing performance-based budgeting, increasing our focus on core support functions, and reforming our annual review of programs and funding.

Although the Department received a disclaimer of opinion on its financial statements, there have been advancements throughout the past year in the Department's efforts to improve financial reporting and management processes. Specifically, through the Department's Business Management Modernization Program, the financial management processes and controls are being integrated into the business processes to ensure accountability and auditability of the Department's business transactions.

The Department now has a report card that identifies how well we did in achieving the strategic plan, objectives, and goals. This is an effective management tool that is allowing us to fine-tune our implementation of the strategic plan. Looking at our report card results this year, the Department met several of its performance goals, but still has work to do in other areas. The report displays all of the Department's performance results this year and provides a clear picture of our progress in meeting our objectives.

The Department is committed to effective internal controls, full compliance with established guidelines and standards, and proper stewardship of the resources entrusted to it. During fiscal year 2004, we corrected 11 management control weaknesses, and except for the unresolved weaknesses noted in the Management Discussion and Analysis section of this report, the Department has reasonable assurance that its management controls are effective. The Department will continue its efforts to resolve the remaining issues and I am confident that the Department will continue to fulfill its mission responsibilities.

Looking ahead, the Department continues the transformation of its support structure and management practices. While the Department has made progress in many areas, we must continue to upgrade performance and accountability, streamline and strengthen management, and ensure that every defense dollar is expended as wisely as possible.

Paul Wolfowitz

Report Overview

The Department of Defense fiscal year 2004 Performance and Accountability Report is designed to provide useful information for American citizens, the President, Congress, other federal organizations, and Department of Defense military members, civilians and contractors.

Our report encompasses the Department's operations for fiscal year 2004, which occurred from October 1, 2003, through September 30, 2004. It contains five parts. Combined, they provide a thorough description of the Department's services to the American people and stewardship of our critical resources.

The pressures on the Department's resources have never been greater and will continue to grow in the years ahead. Our response must be to focus relentlessly on efficient and careful use and management of these resources. Only by effectively measuring the results we achieve, as documented in this report, can we adjust the tactics and strategies we use to meet our goal of mission excellence and deliver the best possible performance for the American people.

Part 1: Management Discussion and Analysis is a high-level overview of the Department's performance and financial information for fiscal year 2004. Part 1 starts with a discussion of the Department of Defense (DoD) mission, organization and resources. It highlights the Department's performance—covered in more detail in Part 2—by summarizing the strategic plan and goals and the fiscal year 2004 annual performance goals and results. Next, it provides financial highlights—covered in more detail in Part 3—for fiscal year 2004. The Department's compliance with legal and regulatory requirements is also discussed in this section. Part 1 concludes with a summary of the Department's status on meeting the President's Management Agenda objectives.

Part 2: Performance Information presents the Department's strategic plan, strategic objectives, annual performance goals, and annual performance results for fiscal year 2004 in accordance with the Government Performance and Results Act. It describes key performance indicators—and their fiscal year 2004 goals and results—that the Department uses to manage risks to the accomplishment of its strategic objectives.

Part 3: Financial Information is composed of the Department's principal financial statements, notes to these statements, consolidating and combining statements, and other required information for fiscal year 2004. This section includes the Inspector General, Department of Defense, Auditors' Report on the fiscal year 2004 financial statements. The Auditors' Report provides the Inspector General's assessment of whether the Department's financial statements are fairly presented in all material respects and conform to generally accepted accounting principles.

Part 4: Inspector General Summary of Management Challenges presents a summary of the most serious management challenges facing the Department. This assessment was prepared by the Inspector General, Department of Defense.

Part 5: Appendixes present detailed information about the Department's compliance with the Improper Payments Information Act of 2002, a glossary of acronyms, and a list of internet links for further information referred to in this report.

We are interested in your feedback regarding the content of this report. Please feel free to email your comments, or requests for copies of this report, to DoDPAR@osd.mil or write to:

U.S. Department of Defense
Office of the Under Secretary of Defense
(Comptroller)
1100 Defense Pentagon
Washington, DC 20301-1100

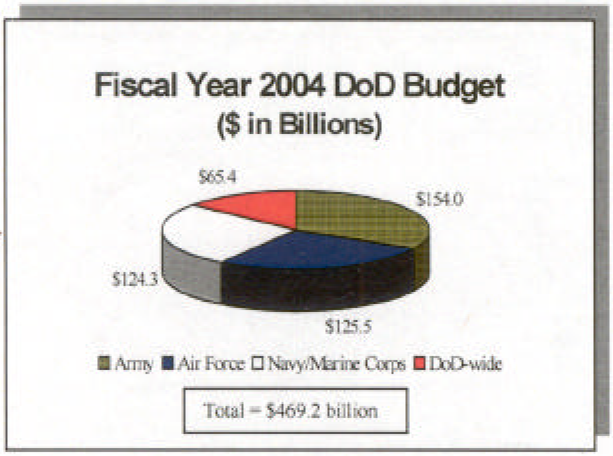
You may also view this document at www.dod.mil/comptroller/par.

Resources

People. To provide the citizens of the United States with the highest level of national security, the Department of Defense employs 1.4 million men and women in the Active Duty, another 1.2 million in the Reserve and National Guard, and approximately 740,000 civilians. Together, these men and women work daily to protect American interests in numerous countries.

Physical Assets. The Department maintains a robust infrastructure, operating approximately 600,000 individual buildings and structures located at more than 6,000 different locations, and using approximately 30 million acres. To protect the security of the United States, the Department uses approximately 250,000 vehicles, 15,000 aircraft, 1,000 oceangoing vessels, and 550 public utility systems.

Budget. The Department's budget for fiscal year 2004 was $469.2 billion.[2]



Because the American people have entrusted these resources to the Department of Defense, the Department is committed to effective resource stewardship and has implemented numerous performance and financial measures to help meet that commitment. The Department continues to research and develop new methods and measures to enhance management and stewardship of these resources.

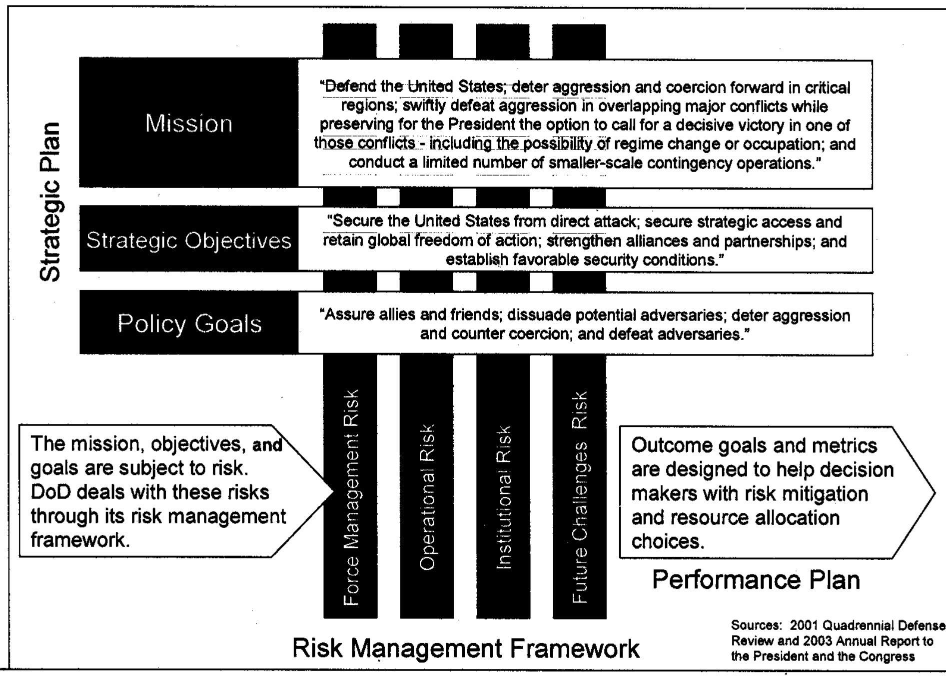
[2] Does not include Trust Fund or U.S. Army Corps of Engineers Civil Works appropriations.

Today, the Department has more than 70 performance metrics in use or under development. The report highlights them in the next two sections, "Performance Highlights" and "Financial Highlights," and they are detailed in Part 2, "Performance Information" and Part 3, "Financial Information."

Annual Performance Goals and Results

Managing risk is a central element of the defense strategy. It involves balancing the demands of the present against preparations for the future consistent with the strategy's priorities. To do this in a consistent, analytic manner, the Department introduced in 2001 a new risk management framework to help the Secretary and his advisors evaluate tradeoffs among key performance objectives and fundamental resource constraints.

The risk categories are described and illustrated below. Each category has associated outcome goals and metrics designed to gauge performance. This creates a continuous thread to ensure the Department's performance supports the strategy.



The **Risk Management Framework** ties the **Performance Plan** to the **Strategic Plan** with outcome goals and metrics designed to measure how well the Performance Plan mitigates risks.

1. Force management risk addresses our ability to recruit, retain, train, and equip sufficient numbers of quality personnel and sustain the readiness of the force while accomplishing our many operational tasks.

2. Operational risk focuses on achieving military objectives in a near-term conflict or other contingency.

3. Institutional risk covers the management practices and controls that affect the efficiency with which resources are used and that shape the effectiveness of the Defense establishment.

4. Future challenges risk addresses new capabilities and new operational concepts needed to dissuade or defeat mid-term to long-term military challenges. This risk management framework reflects DoD's experiences over the last decade in attempting to balance strategy, force structure, and resources.

Each of these quadrants is further defined by specific outcome goals. By assessing the Defense establishment in these four areas against those goals, the Department can directly assess how well it is developing and transforming the operational force, realizing key enabling capabilities, and providing the deployment and support infrastructure needed to achieve the strategic goals of the defense strategy.

Financial Highlights

Key Financial information is summarized in this section with detailed financial information provided in Part 3 of this report.

Financial Overview

The Department of Defense continues to improve financial management by overhauling the Department's business and financial management processes and systems. This represents a major management challenge that goes far beyond financial accounting. The Secretary and his senior leaders are committed to changing the Department's business culture, thus improving the Department's combat support infrastructure.

Each year the Department spends billions of dollars designing, building, operating and maintaining business systems that support the troops. Many of these systems support one military service, a specific defense agency, or in some cases, an individual command. Consequently they are unable to operate as a single enterprise network of systems. The Armed Forces of the United States must have business systems that can interact with one another and facilitate the execution of end-to-end business processes; provide DoD decision makers with timely, accurate, and reliable information; comply with all financial management laws, standards, and requirements; and produce auditable financial statements.

Furthermore, the transformation of the business management systems and the business processes they support must be accomplished without interrupting the level of support provided to the warfighter and on-going military operations. This unprecedented, comprehensive, and visionary task remains one of the Department's top priorities.

The Department has already made progress in transforming its business and financial processes and systems.

Nearly 50 percent of the Department's total liabilities received an unqualified audit opinion again this year

As indicated by the table below, six of the Department's subordinate financial statement reporting entities received unqualified audit opinions, one received a qualified audit opinion, and three of the Department-wide financial statement items received favorable audit results. As a result of the Military Retirement Fund receiving an unqualified audit opinion, nearly 50 percent of the Department's total liabilities received unqualified audit opinion again this year.

DoD Component	Audit Opinion
Defense Commissary Agency	Unqualified
Defense Contract Audit Agency	Unqualified
Defense Finance and Accounting Service	Unqualified
Defense Threat Reduction Agency*	Unqualified
Military Retirement Fund	Unqualified
Medicare Eligible Retiree Health Care Fund	Qualified
Inspector General, DoD*	Unqualified
DoD-Wide Financial Statement Lines	**Audit Results**
Appropriations Received*	Favorable
Federal Employee Contribution Act Liabilities*	Favorable
Investments*	Favorable

* = New for fiscal year 2004

DoD is accomplishing the difficult task of business transformation and improved financial management through the business management modernization program, financial improvement initiative, and financial management balanced scorecard.

Business Management Modernization Program. During the three years since the Department of Defense began the business management modernization program, significant progress has been achieved in building a baseline architecture, governance structure, and re-engineering methodology to reach the ultimate goal of streamlining and integrating business processes and systems. In 2004, the Department achieved the following.

- Developed specific business transformation metrics that are tied directly to goals, objectives and targets. These metrics represent the program's first set of integrated business transformation metrics.

- Implemented an incremental approach to transformation, which allows DoD to prioritize and focus on the most pressing business transformation initiatives. Although the Department previously had defined Increment 1 (obtaining better financial traceability, total asset accountability, and total personnel visibility), it had not done so for the increments subsequent to it. Increment 2 will focus on reengineering the Department's method of contracting for and acquiring goods and services, accounting for physical assets, and improving military health care delivery. Increment 3 will focus on improving the Programming, Planning, Budgeting and Execution process and achieving an integrated total force picture.

- Established portfolio management policies and broadly outlined duties and responsibilities for managing information technology investments across the department.

- Released version 2.2 of the business enterprise architecture, which includes an enterprise business process model, describing the end-to-end business processes for DoD; it also incorporates statutory, regulatory, and administrative requirements and procedures. Visibility of these requirements in the context of DoD business operations is necessary to correct deficiencies, assure uniform interpretation and implementation, and provide timely, accurate and reliable business information.

The Department will incorporate the remaining statutory, regulatory, and administrative requirements in future versions of the business enterprise architecture. The timetable for these improvements is outlined in the table below.

Release Dates for Future Versions of the Business Enterprise Architecture:

Description	Release Date
Release of Business Enterprise Architecture Version 2.3 *Updates all business enterprise architecture work activities, information, system functions and interchanges needed to support the defined enterprise business process model.*	November 2004
Release of Business Enterprise Architecture Version 2.4 *Continue to detail enterprise business process model. Addresses remaining statutory, regulatory, and administrative requirements and map those deemed financially relevant to the enterprise business process model for increment 1.*	January 2005

Through the above accomplishments, DoD has laid the groundwork for significant progress during the coming year. The work is proceeding steadily. The scope and complexity of DoD business processes and systems are too large and unwieldy to change all at once and the transformation will take time. Long term efforts will focus on the following integrated activities.

- Incrementally build and extend a business enterprise architecture,

- Establish and enforce an agency-wide governance process that ensures efficient execution, guidance, and oversight for DoD business transformation and compliance activities,

- Reduce or eliminate redundant, outdated, and stove-piped systems using a systems review and portfolio management process, and

- Reengineer the Department's business processes a piece at a time using an incremental approach.

For detailed information on the Department's Business Management Modernization Program, visit www.dod.mil/comptroller/bmmp/pages/index.html/

Financial Improvement Initiative. Although strategic change through the business management modernization program will take time, the department is taking steps to correct weaknesses and deficiencies using the discipline and methodology of financial audits.

To help meet this objective, the Department launched the financial improvement initiative in 2003. The goal of the financial improvement initiative is to ensure proper transfer of good data and processes into the broader reengineered business processes. By cleansing data and reengineering processes based on the rules documented in the business enterprise architecture, the Department will mitigate the risk of importing poor data and poor controls into the new architecture.

To accomplish the goal of receiving an unqualified audit opinion, the DoD components developed and submitted financial improvement plans listing deficiencies and necessary corrective actions. The financial improvement initiative has allowed the Department to:

- Better define and align financial statement deficiencies to financial statement lines,
- Begin linking deficiencies to enterprise business process model processes, and
- Provide Department-wide oversight and visibility to improving financial statements.

The improvement plans identify deficiencies that must be corrected through policy revisions, process improvements, or systems changes. This information is being linked to the Business Management Modernization Program so that the Department can clearly distinguish between problems that can be solved in the near term through policy and process actions and problems that must be solved through systems changes.

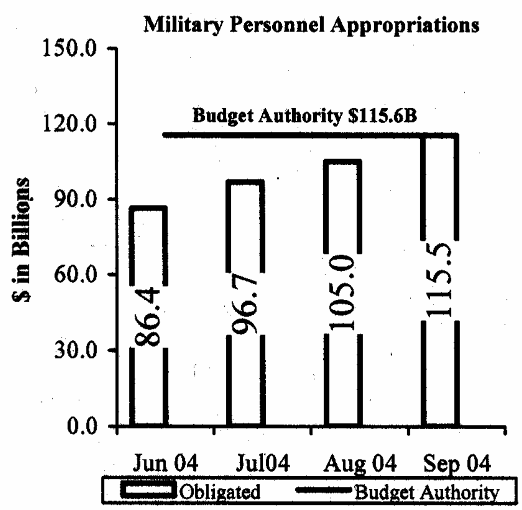
Financial Management Balanced Scorecard. The Department's Financial Management Balanced Scorecard is aligned with the risk management framework established in the Department's strategic plan. The Scorecard provides the framework for establishing executive-level performance goals and tracking results; designates key performance outcomes, measures, and indicators; and assigns responsibility for cascading performance metrics to the individual component levels within the Department.

Budget and financial indicators are used to monitor and guide financial management reform and target resources to areas where DoD needs to drive better stewardship of financial resources.

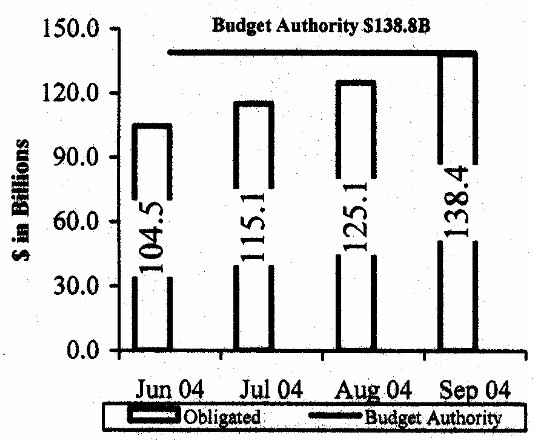
Execution of Appropriations

Military Personnel and Operation and Maintenance Appropriations

The Department obligated 99.9 percent of its Military Personnel Appropriations and 99.7 percent of its Operation and Maintenance Appropriations. The Department developed the following Military Personnel Appropriations and Operation and Maintenance Appropriations indicators to monitor the execution of DoD's budget and project the rate and amount of funds the Military Services obligate. The Department compares each appropriation's annual budget authority with each Service's projected obligations to ensure funds are available to finance the requirement.

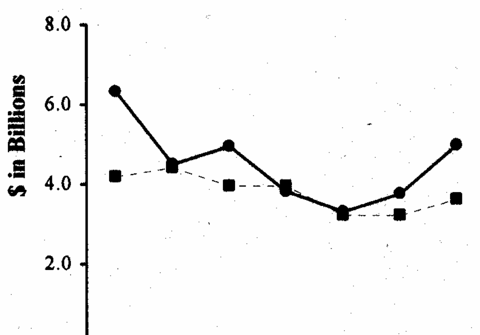


Operation and Maintenance Appropriations



Defense Working Capital Fund
Cash Management

Cash Management within the Defense Working Capital Fund is defined as the ability to maintain sufficient liquidity to meet current obligations and accurately forecast cash requirements. The Department transferred $3.8 billion in fiscal year 2004 to Operation and Maintenance appropriations. Cash is inflated in fiscal year 2004. Higher than normal inventory sales in fiscal year 2004, due to the global war on terror and pricing of transportation services, has generated substantial cash. However, when this inventory is replaced and with lower transportation pricing, cash will decrease significantly to pay for the restocking of inventory in fiscal year 2005. The fiscal year 2004 ending cash balance is $4.99 billion.

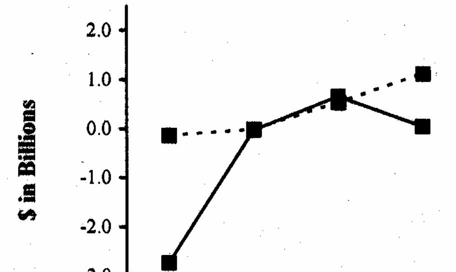


	Mar 04	Apr 04	May 04	Jun 04	Jul 04	Aug 04	Sep 04
Current Bal.	6.31	4.52	4.94	3.82	3.30	3.77	4.99
Plan	4.2	4.42	3.97	3.94	3.25	3.22	3.64

Defense Working Capital Fund
Accumulated Operating Results

The Defense Working Capital Fund Accumulated Operating Results (AOR) indicator reflects the cumulative operating gain or loss since inception for each industrial type business area. This indicator displays the variance between the phased plan for AOR provided in the budget and the actual AOR reported in the monthly financial reports.

Overall, the revenue is above plan by $3.2 billion and expenses are above plan by $1.7 billion, due to the global war on terror. However, Recoverable Operating Results were reduced by $0.8 billion to recognize the impact of cash transfers. As a result, the Department's fiscal year (FY) 2004 AOR of $0.06 billion was less than the planned $1.14 billion.



	FY 2001	FY 2002	FY 2003	FY 2004
Actual AOR	-2.73	-0.02	0.67	0.06
Plan	-0.13	0.00	0.55	1.14

Late Payments of Commercial Invoices

The Prompt Payment Act requires that invoices be paid on time—within 30 days of receipt. This indicator highlights the degree to which the Department is able to reduce untimely commercial payments. DoD's fiscal year 2004 goal was to reduce late payments to a level not to exceed 3 percent of total commercial invoices. The Department exceeded the goal by reducing late payments to 2.6 percent. Improving this indicator reduces cost and improves DoD's relationship with suppliers.

Delinquent Accounts Receivable

The Accounts Receivable indicator highlights the amount owed to the Government by an individual, organization, public entity, foreign entity, or any other entity to include federal entities, to satisfy a debt or claim.

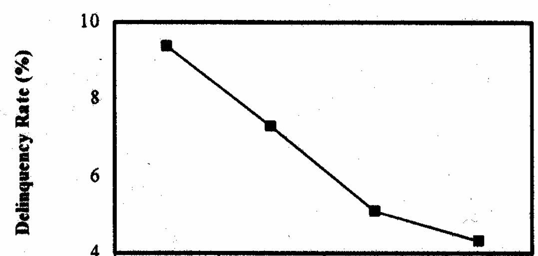
The Department's goal was to reduce delinquent receivables (more than 30 days old) by 25 percent in fiscal year 2004. The Department has two types of delinquent receivables: receivables with the public (i.e., individuals, contractors, local and foreign governments, etc.) and intragovernmental receivables with other federal government agencies.

Approximately $4.0 billion of the $4.9 billion delinquent public receivables were at Treasury for collection or in litigation. DoD is actively working to collect the remaining $0.9 billion in delinquent public receivables. The Department's delinquent public receivables, for which DoD controls collecting, decreased by 21 percent in fiscal year 2004.

Delinquent intragovernmental receivables owed to the Department by other federal agencies are currently $302 million. The Department reduced these receivables by 16 percent in fiscal year 2004.

DoD Travel Card Program
Individually Billed Accounts Delinquency Rates

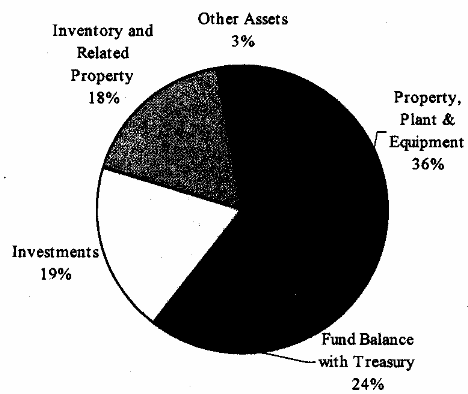
This indicator illustrates the Department employees' record for paying their travel card invoices in a timely manner—within 60 days. The Department measures the percent of delinquent payments relative to the total billed amounts. A low delinquency rate accrues cash benefits to the Department in the form of rebates and improves the credibility of the travel and purchase card programs with both the Congress and the general public. Since fiscal year 2001, delinquency rates for individual travel accounts declined 54 percent, from 9.4 percent delinquent to 4.3 percent delinquent.



	Sep 01	Sep 02	Sep 03	Sep 04
DoD	9.4	7.3	5.1	4.3

Financial Statement Analysis

Types of Assets



Assets. The Consolidated Balance Sheet shows that DoD assets as of September 30, 2004, were $1.2 trillion, an increase of $67.2 billion (6%) from fiscal year 2003.

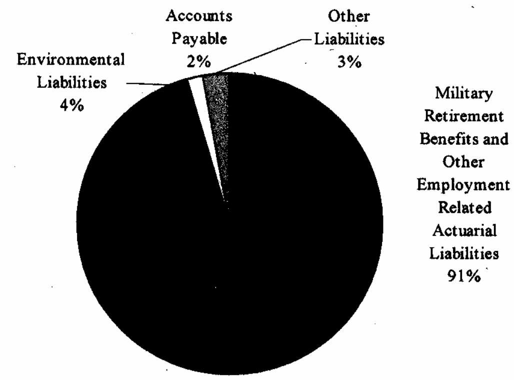
Increased funding to fight the global war on terror caused the Fund Balance with Treasury to increase $37.5 billion.

Investments increased by $25.9 billion primarily due to positive security cash flows for the Military Retirement Trust Fund and the Medicare Eligible Retiree Health Care Fund for retired military members and their dependents.

Assets

Asset Type	Fiscal Year 2004	Fiscal Year 2003	Change
	Billions		
Property, Plant, and Equipment	$440.9	$446.3	-$5.4
Fund Balance with Treasury	$289.6	$252.1	$37.5
Investments	$231.5	$205.6	$25.9
Inventory and Related Property	$213.2	$205.5	$7.7
Other Assets	$33.3	$31.8	$1.5
Total	**$1,208.5**	**$1,141.3**	**$67.2**

Types of Liabilities



Liabilities. The Consolidated Balance Sheet shows that DoD liabilities as of September 30, 2004, were $1.7 trillion, an increase of $150.5 billion (10%) from fiscal year 2003.

Military Retirement Benefits and Other Employment Related Actuarial Liabilities increased $140.1 billion primarily due to a new law which allows certain disabled military retirees to concurrently receive disability payments from the Veterans Administration and their DoD military retirement pay. Prior to this legislation, disability payments offset military retirement payments by an equal amount.

Environmental Liabilities increased by $2.9 billion primarily due to improved accuracy in the reporting of environmental liabilities.

Accounts Payable increased by $2.2 billion primarily due to the global war on terror.

Liabilities

Liability Type	Fiscal Year 2004	Fiscal Year 2003	Change
	Billions		
Military Retirement Benefits and other Employment Related Actuarial Liabilities	$1,569.7	$1,429.6	$140.1
Environmental Liabilities	$64.4	$61.5	$2.9
Accounts Payable	$30.2	$28.0	$2.2
Other Liabilities	$45.8	$40.5	$5.3
Total	**$1,710.1**	**$1,559.6**	**$150.5**

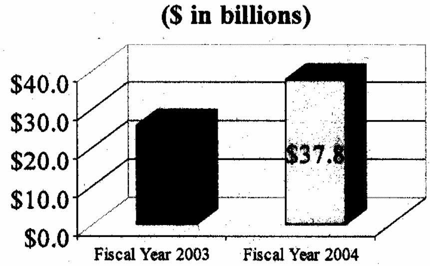
Costs. The Consolidated Statement of Net Cost shows that the net cost of operations for the Department of Defense for fiscal year 2004 was $605.4 billion, an increase of $93.1 billion (18%) from fiscal year 2003. The principal reasons for this increase were the military retirement program's new legislation just discussed and the global war on terror. As indicated by the table below, increases occurred in several major military programs to support this effort. Most notably, the Department's military retirement costs increased $52.2 billion due to increased actuarial liabilities. In addition, costs to operate, maintain, supply and transport forces increased by $14.6 billion. The *Consolidating Statement of Net Cost* provides a more detailed breakout of the Department's costs.

Costs

Program Type	Fiscal Year 2004	Fiscal Year 2003	Change
	Billions		
Military Personnel	$112.3	$108.9	$3.4
Operation & Maintenance	$187.1	$172.5	$14.6
Procurement	$79.2	$60.0	$19.2
Research, Development, Test & Evaluation	$56.8	$51.1	$5.7
Military Retirement	$153.5	$101.3	$52.2
Other Programs	$16.5	$18.5	-$2.0
Total	**$605.4**	**$512.3**	**$93.1**

Revenues. The Consolidated Statement of Net Cost shows that the total revenues received by the Department for fiscal year 2004 were $37.8 billion. This is a $12.0 billion (47%) increase in revenues from fiscal year 2003. The increase in revenues was mainly due to the U.S. Treasury directing that other gains on assets be treated as revenue, whereas previously other gains were netted against costs.

Revenues
($ in billions)

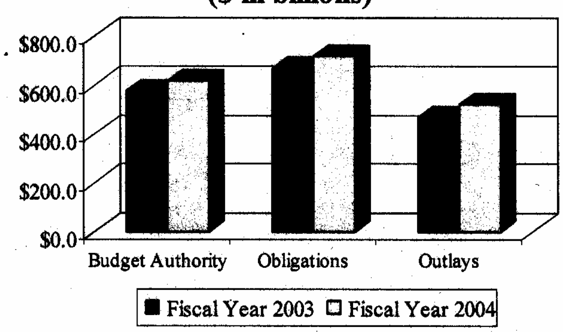


Budget Authority. This is the authority provided by law to incur financial obligations that will result in outlays. Specific forms of budget authority include appropriations, borrowing authority, contract authority, and appropriation transfers from other agencies. The Combined Statement of Budgetary Resources shows that the amount of budget authority the Department had for fiscal year 2004 was $616.5 billion. This is a $40.0 billion (7%) increase from fiscal year 2003. Increased funding to fight the global war on terror caused this increase and the corresponding increases to both obligations and outlays, which are discussed below.

Obligations. An obligation is a binding agreement that will result in outlays, immediately or in the future. Budgetary resources must be available before obligations can be incurred legally. The Combined Statement of Budgetary Resources shows that obligations made during fiscal year 2004 were $720.9 billion, an increase of $51.1 billion (8%) from fiscal year 2003.

Outlays. An outlay is a payment to liquidate an obligation (other than the repayment of debt principal). Outlays generally are equal to cash disbursements, but also are recorded for cash-equivalent transactions, such as the subsidy cost of direct loans and loan guarantees, and interest accrued on issues of public debt. Outlays are the measure of government spending. The Combined Statement of Budgetary Resources shows that outlays made during fiscal year 2004 were $521.1 billion, an increase of $52.6 billion (11%) from fiscal year 2003.

Statement of Budgetary Resources
($ in billions)



Compliance with Legal and Regulatory Requirements

Each year the Department works aggressively to comply with laws made by Congress to ensure that the federal government provides the best possible service to the American people. Among these laws are the:

- Chief Financial Officers Act of 1990
- Federal Managers' Financial Integrity Act of 1982
- Federal Financial Management Improvement Act of 1996
- Inspector General Act Amendments of 1988
- Improper Payments Information Act of 2002

Chief Financial Officers Act

The Chief Financial Officers Act requires federal agencies to prepare auditable annual financial statements. Each year, the Department prepares financial statements.

As discussed earlier, several of the Department's subordinate agencies have received a favorable audit opinion on their financial statements. However, to date, the DoD-wide statements have received a disclaimer of opinion from the auditors, which means the statements are not able to be audited.

The Department created detailed financial improvement plans. These plans identify specific corrective actions, costs, and key milestones for improving the information reported in the Department's financial statements.

To minimize the funds spent on audits until the financial statements are ready for audit, the Department implemented a rigorous five phase process in FY 2004. Phase one requires entities to identify and correct deficiencies in financial reporting. In phase two, management is required to validate that the deficiencies were corrected. After the validation, management is to assert to the auditors that the information is reliable in phase three. The assertion process contains detailed requirements for documenting the basis for asserting. In phase four, the auditors perform an assessment to determine audit readiness. If the information is ready, the auditors will perform a full audit in phase five.

The Department currently has 11 auditor identified financial statement material weaknesses. A summary of these weaknesses and their corrective status follows.

Financial Statement Weakness	Description	Status
Financial Management Systems	The DoD systemic deficiencies in financial management systems and business processes result in the inability to collect and report financial and performance information that is accurate, reliable, and timely.	The Department developed the initial version of a new business enterprise architecture. The architecture helps describe how the Department's business processes and systems will integrate to ensure that accurate and timely financial information is readily available for decision makers.
Intragovernmental Eliminations	The inability to reconcile most intragovernmental transactions results in adjustments that cannot be fully supported.	The Department is taking action internally and with other federal agencies to help resolve this issue.
Accounting Entries	The DoD continues to enter material amounts of unsupported accounting entries.	The Department has implemented a training program to minimize unsupported accounting entries and is tracking progress through the financial metrics program. Total elimination of these entries is contingent upon full implementation of the Department's business enterprise architecture, new systems, and business processes.
Fund Balance with Treasury	The Department has been unable to fully reconcile its records to those of the U.S. Treasury.	The Department strengthened internal controls for disbursements through reconciliation training and metric tracking to more accurately record disbursements. The Department also obtained legislation to clear old unreconcilable suspense accounts and check issue differences. The Department has a multi-phase program underway to enhance system functionality for improving expenditure reconciliation and reporting.
Environmental Liabilities	Guidance and audit trails are insufficient. The inventory of ranges and operational activities (landfills, open burning pits, etc.) is incomplete.	The Department issued guidance for closed sites in October 2002 and continues to issue guidance for on-going operations. Inventories of operational and non-operational ranges are complete. Additional review and validation is needed to ensure audit trails are sufficient.

Financial Statement Weakness	Description	Status
General Property, Plant and Equipment (PP&E)	The cost and depreciation of DoD General PP&E is not reliably reported due to: (a) a new accounting requirement that went into effect in FY 2003 that classifies military equipment as General PP&E (such costs were previously expensed), (b) a lack of supporting documentation for General PP&E which were purchased many years ago, and (c) most legacy property and logistics systems are not integrated with acquisition and financial systems and were not designed to capture the acquisition cost, cost of modifications and upgrades, or calculate depreciation.	The Department implemented guidance and training to improve property accountability and provide better financial reporting. The Department plans to complete valuations of all known military equipment programs by September 2005. The military equipment baseline will be updated to a single base year in fiscal year 2006. The Department plans to develop a white paper on accounting and reporting for spare parts, based on the practices of other Federal agencies and private sector organizations. The paper will be submitted to the Federal Accounting Standards Advisory Board, with resolution anticipated by March 2005.
Government Property and Material in the Possession of Contractors	The cost of DoD property and material in the possession of contractors is not reliably reported due to a lack of an integrated reporting methodology.	The Department is developing policy and processes to help correct this weakness. Implementation of new policy and the Department's business enterprise architecture will eliminate this problem. To improve accountability, accuracy, and reliability, DoD is in the process of creating an on-line government property system to be jointly used by government and industry for recording property in the possession of contractors.
Inventory	The existing inventory valuation at most activities is not reported in accordance with generally accepted accounting principles.	The Department issued a change in policy in fiscal year 2001 to begin valuing inventory at moving-average-cost to comply with historical cost valuation requirements. In fiscal year 2004, the Department chartered the Inventory and Operating Materials and Supplies Working Group to identify and develop processes and methods leading to inventory valuation based on historical costs. This effort involves assessing the Department's major logistics and financial systems—current and future—to determine the adequacy for producing historically-based valuations. The working group is developing valuation techniques where standard methods are not feasible or practical.

Financial Statement Weakness	Description	Status
Operating Materials and Supplies	The Department's systems were designed to expense materials when purchased rather than when consumed.	The Inventory and Operating Materials and Supplies Working Group is addressing this issue by examining the Department's practices, processes, and systems to determine the appropriate Department-wide business rules and systems that will correct this weakness.
Statement of Net Cost	The Statement of Net Cost is not presented by programs that align with major goals and outputs described in the DoD's strategic and performance plans required by the Government Performance and Results Act. Revenues and expenses are reported by appropriation categories because financial processes and systems do not collect costs in line with performance measures.	The implementation of the Department's business enterprise architecture will correct this weakness.
Statement of Financing	The DoD cannot reconcile budgetary obligations to net cost without making unsupported adjustments.	The implementation of the Department's business enterprise architecture will correct this weakness.

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act requires federal agencies to assess the effectiveness of management controls for program, operational, and administrative areas as well as accounting and financial management. Management controls are the organization, policies, and procedures which are considered the tools that help program and financial managers achieve results and safeguard the integrity of their programs.

Using self-assessments as the basis, this Act requires agency heads to provide an annual statement of assurance on the effectiveness of the management controls and to include material weaknesses found in management controls that warrant reporting to a higher level. The Department's fiscal year 2004 Annual Statement of Assurance is provided in the Deputy Secretary's Message at the front of this report.

Maintaining integrity and accountability in programs and operations:

(1) is critical for good government,
(2) demonstrates responsible stewardship over assets and resources,
(3) promotes high-quality, responsible leadership,
(4) enhances the sound delivery of services to customers, and
(5) maximizes desired program outcomes.

In fiscal year 2004, the Department took numerous steps to improve the Department-wide training, awareness, communication, and emphasis for full disclosure and prompt resolution of weaknesses. Early in the year, the Department conducted a Department-wide conference attended by more than 100 representatives from 70% of the Department's components. The Controller of the Office of Management and Budget helped kick off the conference and made the case for the importance of identifying and promptly resolving material weaknesses in the functional area of financial reporting. At the conference, the Department introduced a newly designed DoD scorecard used to measure important elements of the Defense components' feeder statements. These feeder statements are essential in developing the DoD Statement of Assurance. The categories scored in the development of the DoD feeder statements are the timeliness of the statements, accuracy and completeness of the feeder reports, program execution and training to ensure robust assessments of the management controls, full disclosure of material weaknesses, and prompt resolution of previously reported material weaknesses. The scorecard has already improved the timeliness of component feeder statements. In fiscal year 2003, only 48% of the feeder statements were received on time. This fiscal year 88% of the feeder statements were on time.

Beginning at mid-year in fiscal year 2004, the Department began using the automated system, Financial Information Progress System, to quarterly track and update the progress of corrective actions for reported weaknesses. Quarterly tracking has increased the leaderships' awareness of the importance the Department places on prompt resolution of reported weaknesses.

In fiscal year 2004, the Department conducted training briefings for 25 percent of the Defense components. In addition, the Department conducted training at the American Society of Military Comptrollers national training session, the Professional Military Comptroller School, and a Senior Executive Service orientation class.

The Department strongly encourages forthright reporting of material weaknesses in management controls on all operations important to accomplishing the mission of defending our nation from adversaries, foreign or domestic. As weaknesses are corrected, new ones may be identified and the total number of weaknesses can fluctuate. Therefore, the outstanding number of uncorrected weaknesses may not change significantly from one fiscal year to another. The Department monitors corrective activities and does not allow milestone slippage without justification by senior leaders. In fiscal year 2004, the Department notified the leaders of all DoD component activities that failure to correct material weaknesses in a timely manner is unacceptable. One of the main reasons for the inability to correct weaknesses on time has been overly optimistic projections. The Department is emphasizing the importance of using more realistic projections.

The Department uses periodic self-assessments as the basis for the annual statement of assurance and reports management control weaknesses relating to Sections 2 and 4 of the Federal Managers' Financial Integrity Act. Section 2 requires "internal accounting and administrative controls that reasonably ensure costs comply with applicable laws, assets are safeguarded, and revenue and expenses are recorded and accounted for properly." Section 4 requires that "accounting systems conform to principles, standards or related requirements prescribed by the Comptroller General."

The Department classifies management control weaknesses into 3 categories:

1. **Section 2 Systemic Weaknesses:** Weaknesses materially affecting management controls across organizational and program lines and usually affecting multiple DoD components.

2. **Section 2 Material Weaknesses:** Weaknesses materially affecting management controls that warrant reporting to a higher level and usually affect a single DoD component.

3. **Section 4 System Nonconformance Weaknesses:** System nonconformance with the principles, standards or related requirements prescribed by the Comptroller General.

Last fiscal year, the Department had 40 uncorrected Section 2 weaknesses. In fiscal year 2004, the Department reported 17 new weaknesses and corrected 11 weaknesses, leaving 46 uncorrected weaknesses at the end of fiscal year 2004. Of the 17 new weaknesses, 1 is systemic and 16 are material weaknesses. The Department began fiscal year 2004 with 17 financial weaknesses of which 5 were systemic and 12 were material. During the year, the Department corrected 5 relating to financial issues and reported 5 as new material weaknesses, ending the year with a total of 17.

The Department identified 9 areas that affect numerous DoD components as systemic weaknesses. The Department identified the remaining 37 weaknesses as material weaknesses affecting the individual components as indicated on the table below.

In fiscal years 2002, 2003, and 2004, the Department reported one Section 4 System Nonconformance Weakness which encompasses the entire DoD financial system noncompliance with control requirements. The Department also considers DoD financial system's noncompliance as a systemic weakness affecting multiple DoD components. In addition, the auditors have identified DoD financial systems as a material weakness under the requirements of the Chief Financial Officers Act in fiscal years 2002, 2003, and 2004.

The following four tables list the weaknesses grouped differently as Section 2 (corrected or ongoing) and Section 4 (ongoing only).

Table I, Section 2 Corrected Material and Systemic Weaknesses lists 11 corrected during this fiscal year (10 material and 1 systemic weakness).

Table II, Section 2 Systemic Weaknesses – Ongoing lists the nine systemic weaknesses that remained opened at the end of fiscal year 2004, one of which was newly identified this fiscal year.

Table III, Section 2 Material Weaknesses – Ongoing lists the 37 ongoing material weaknesses. Twelve are financial issues of which five are new. Twenty-five are related to non-financial issues of which 11 were newly identified this fiscal year. For these material weaknesses, a sample of the corrective actions was selected for reporting. Each material weakness is required to have a validation as the final action to ensure that the weakness is corrected.

Table IV, Section 4 Systemic Weaknesses – Ongoing lists the 1 ongoing Section 4 system nonconformance material weakness.

Table I. Section 2 Corrected Material and Systemic Weaknesses	DoD Component
1. The actual loss of government funds could not always be fully identified because of improper disbursement transaction processing and inadequate documentation. (Material Weakness)	Defense Finance and Accounting Service
2. Due to inadequate supporting documents, freight supply payments are not properly pre-certified before they are made. (Material Weakness)	Defense Finance and Accounting Service
3. Payments less than $2,500 are not always certified and post payment audits are not always performed on electronic vendor payments to verify that the supporting documentation is correct. (Material Weakness)	Defense Finance and Accounting Service

Table I. Section 2 Corrected Material and Systemic Weaknesses (Continued)	DoD Component
4. Adequate management controls were not in place to detect or prevent disbursements in excess of obligations. (Material Weakness)	Office of the Under Secretary of Defense for Comptroller
5. The military pay system has made invalid payments resulting in members separating from service in debt. (Material Weakness)	Defense Finance and Accounting Service
6. Better controls are needed to properly account for proceeds from submarine dismantlement scrap revenues. (Material Weakness)	Defense Threat Reduction Agency
7. Not all DoD components have completed essential continuity of operations plans. (Material Weakness)	Defense Threat Reduction Agency
8. Responsible DoD officials failed to secure host nation telecommunications agreements necessary to maximize the combat effectiveness of warfighters. (Material Weakness)	Department of the Air Force
9. Controls were not adequate to ensure that the program manager of the Joint Chemical Agent Detector—an Acquisition Category III program—reported cost breaches to the acquisition program baseline. (Material Weakness)	Office of the Under Secretary of Defense for Acquisition, Technology and Logistics
10. DoD risks improperly storing Privacy Act information on systems. (Material Weakness)	DoD Counterintelligence Field Activity
11. Acquisition oversight is not always adequate when contracting for DoD services and can result in failure to obtain the best value on individual procurements. (Systemic Weakness) [Management took action to resolve this weakness and reported it closed. However, new concerns identified by auditors during FY 2004 will be reviewed and the impact assessed.]	Office of the Under Secretary of Defense for Acquisition, Technology and Logistics

Table II. Section 2 Systemic Weaknesses -- Ongoing	
Title	**1. Department of Defense Financial Management Systems and Processes**
Description of Issue	The Department of Defense financial and business management systems and processes are costly to maintain and operate, not fully integrated, and do not provide information that is reliable, timely, and accurate.
Progress to Date	A. Completed Milestones: • Created a portfolio management approach to review information technology investments. • Incorporated the Enterprise Business Process Model into the Business Enterprise Architecture release 2.1. • Established integrated goals, objectives, measures, and targets. • Initiated a single Department-wide information technology registry to track all business systems.

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Table II. Section 2 Systemic Weaknesses – Ongoing (Continued)	
Title	**1. Department of Defense Financial Management Systems and Processes (Continued)**
Progress to Date (Continued)	B. Planned Milestones for FY 2005: • Complete the Business Enterprise Architecture (BEA) Increment #1, which includes business processes in support of an unqualified audit opinion. • Perform targeted portfolio management reviews as part of the FY 2005 through FY 2006 planning, programming, and budgeting process. C. Planned Milestones for Beyond FY 2005: • Complete BEA Increment #2, which focuses on business processes that support acquisition practices, total asset visibility, accurate valuation of assets, military health care delivery, and environmental safety and occupational health. • Complete BEA Increment #3, which focuses on business processes that support the planning, programming, budgeting and execution, total force management, and installations management. • Complete targeted portfolio management reviews, which are part of the Department's planning, programming, budgeting, and execution process. **Correction Target Date: 4th Quarter, FY 2007**
Title	**2. Management of Information Technology and Assurance**
Description of Issue	The Department of Defense information systems are potentially vulnerable to an information warfare attack. In addition, this issue has also been reported as a "significant deficiency" under the reporting requirements of the Federal Information Security Management Act.
Progress to Date	A. Completed Milestones: • Expanded the authority of the United States Strategic Command to include network operations and information assurance. • Completed and updated the Department of Defense policies addressing public key infrastructure and enterprise-wide certification requirements for information assurance / technology professionals. • Completed the draft revision and informal coordination of the certification and accreditation policy, which improves compliance and provides an enterprise management capability. • Developed and piloted an automated security certification and accreditation process for information systems. Began the expansion to more robust web based design using shared information and services that deliver improved functionality by interconnecting data transactions into a common database. • Awarded the Department of Defense-wide enterprise license for an information assurance vulnerability scanning tool.

Table H. Section 2 Systemic Weaknesses – Ongoing (Continued)	
Title	**2. Management of Information Technology and Assurance (Continued)**
Progress to Date (Continued)	B. Planned Milestones for FY 2005: • Revise the security certification and accreditation policy in order to improve compliance and to provide an enterprise management capability. • Incorporate a revised certification and accreditation process, including vulnerability management and complete the piloting process. Continue modular development and deployment of additional services to support the information assurance processes, e.g., investment and resource management. • Award the enterprise licenses for automated IA tools to patch vulnerabilities and prevent malicious modification of Operating Systems. C. Planned Milestones for Beyond FY 2005: • Provide the United States Strategic Command real-time situational awareness of the Department of Defense posture. Provide information assurance management tools as a core enterprise service. **Correction Target Date: 3rd Quarter, FY 2007**
Title	**3. Environmental Liabilities**
Description of Issue	The Department of Defense has not developed the policies, procedures, and methodologies needed to ensure that cleanup costs for all of its ongoing and inactive or closed operations are identified, consistently estimated, and appropriately reported. Site inventories and cost methodologies to identify budget requirements and financial liabilities continue to need improvement.
Progress to Date	A. Completed Milestones: • Provided guidance to accomplish an initial operational range inventory. • Reported the operational range inventory to Congress in February of FY 2004. • Completed a real property inventory business process reengineering and presented the concept for Department of Defense-wide review. • Revised the Financial Management Regulation for liability recognition and reporting for operational ranges and munitions response areas. • Published the directive entitled "Sustainment of Ranges and Operating Areas," that requires reporting of environmental remediation liabilities. • Issued planning guidance that requires the assessment of environmental condition of the operational ranges.

Table II. Section 2 Systemic Weaknesses -- Ongoing	
	3. Environmental Liabilities (Continued)
Progress to Date (Continued)	B. Planned Milestones for FY 2005: • Develop an inventory of non-Defense Environmental Restoration Program activities. • Develop the non-Defense Environmental Restoration Program liability estimates. • Assess the progress made by the Military Services in reporting complete, accurate, and supported environmental liability data during the review of the FY 2004 financial statements. C. Planned Milestones for Beyond FY 2005: • Update the site inventories and environmental liability estimates of the Defense Environmental Restoration and the non-Defense Environmental Restoration Programs. • Assess the progress made by the Military components in reporting complete, accurate, and supported environmental liability data during review of the FY 2005 financial statements. **Correction Target Date: 1st Quarter, FY 2006**
Title	**4. Personnel Security Investigations Program**
Description of Issue	The Department of Defense hiring is adversely affected because personnel security investigations are backlogged.
Progress to Date	A. Completed Milestones: • Signed an interagency agreement with the Office of Personnel Management to allow the Defense Security Service to use the Office of Personnel Management computer system for tracking and controlling the Department of Defense personnel security investigations and case processing. • Realigned 200 overhead positions in the Defense Security Service to investigator positions, redesigned the organizational structure, closed offices that lacked sufficient work, and deployed "tiger teams" to conduct overseas investigations. Reduced the number of pending cases in the case control management system from over 400,000 to less than 57,000. • Reinforced quality reviews of contractor work. Issued to the contractors cure letters for failing to meet agreed upon timelines. Took back a number of investigations from the contractors. B. Planned Milestones for FY 2005: • 50 percent of the investigations are submitted within the agreed upon timeframes.

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Federal Financial Management Improvement Act

The Federal Financial Management Improvement Act requires federal agencies to conform to the United States Government Standard General Ledger, comply with all applicable federal accounting standards, establish financial management systems that meet government-wide standards and requirements, and support full disclosure of federal financial data, including the costs of federal programs and activities.

The Department does not fully comply with these requirements. However, as part of the Business Management Modernization Program, the Department teamed with IBM to develop an initial version of the business enterprise architecture in April 2003 to help transform business processes and systems. The architecture helps describe how the Department's business processes and systems will integrate to ensure accurate and timely financial information is readily available for decision makers. When the architecture is fully implemented, the Department expects to meet all the requirements of this Act.

Inspector General Act Amendments

The Inspector General Act of 1978, as amended, requires an explanation for all audit reports with recommendations open for more than 1 year. As of September 30, 2004, the Department had 212 audit reports open for more than 1 year. We are implementing many of these recommendations and the savings are estimated to be $7.9 billion. The Department has already closed out and implemented recommendations from 130 audit reports in fiscal year 2004 with claimed monetary benefits of approximately $255 million.

Improper Payments Information Act

The Improper Payments Information Act of 2002, as implemented by the Office of Management and Budget, requires federal agencies to review annually all its programs and activities and identify those which may be susceptible to significant erroneous payments.

DoD's fiscal year 2004 survey did not identify any programs or activities where erroneous payments exceeded the established thresholds (i.e., an error rate greater than 2.5 percent and erroneous payments in excess of $10 million), nor were any found to be susceptible to significant risk. Although the Department is currently under these thresholds for all its programs and activities, the Office of Management and Budget established an additional requirement that all programs initially identified in Section 57, "Information on Erroneous Payments," of Circular A-11, perform all the prescribed steps outlined in its guidance. These steps include the production of a statistically valid estimate of the erroneous payments, implementing a plan to reduce the amount and reporting to the President and Congress on progress. For the Department of Defense, these programs are Military Health Benefits and Military Retirement. The results of the review of these programs are highlighted below.

Military Health Benefits. The military health benefits program has numerous prepayment and post payment controls built into the claims processing system to minimize improper payments.
One control is the claims edit system, which rebundles services that should be billed under a single code. Procedure unbundling occurs when two or more procedure codes are used to describe a service when a single comprehensive code exists that accurately describes all services performed. This is a poor practice, one that seeks to increase reimbursement.

An example of this practice is laboratory test unbundling. A laboratory can perform numerous tests from a single blood sample. Separate charges for each test inflates the billing, as illustrated here:

Unbundled Billing	
Cholesterol, serum (82465):	$ 6.98
Lipoprotein (HDL cholesterol) (83718):	$13.14
Triglycerides (84478):	$ 9.24
TOTAL:	**$29.36**

Rebundled (Proper) Billing	
Lipid panel (80061) (includes cholesterol, lipoprotein and triglycerides):	**$21.50**

A cost avoidance of $87.6 million was realized in fiscal year 2003 as a result of the military health benefits program rebundling edits. Anticipating that the trend will continue, the Department projects approximately a 10% increase in the amount of the cost avoidance for fiscal year 2004.

The Department projected $100.1 million of improper payments (underpayments and overpayments) for the military health benefits program – purchased care program – in fiscal year 2004. This represents an error rate of approximately 2.16% of the $4.6 billion in military health benefits program payments made during fiscal year 2004. The 2.16% is a preliminary payment error rate. The final payment error rate is not available until the administrative process associated with the audits has been completed, which is targeted for September 2005. Historically, the final figure has been less than the 2% threshold allowed by contract. In support of this position, last year's DoD Performance and Accountability Report listed the preliminary payment error rate for fiscal year 2003 as 1.36%. The final payment error rate for fee-for-service claims was 0.85%.

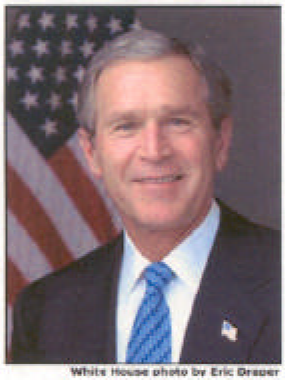
Although health benefit dollars are used to also pay for expenditures incurred under the U.S. Family Health Plans and other areas, these were not identified as being susceptible to significant erroneous payments. Therefore, they are excluded.

Military Retirement. The Department conducts various types of prepayment and postpayment reviews for military retirement payments. One example is that all payments more than $9,000 made to retirees and more than $5,500 made to annuitants are reviewed. Another example is a monthly review of the retired military pay file for similar social security numbers, which helps minimize duplicate payments.

The Department projected $34.1 million of improper payments (underpayments and overpayments) for the Military Retirement Program in fiscal year 2004. This represents an error rate of 0.0952% of the $35.8 billion in military retirement payments made during fiscal year 2004.

For further reporting details about the Improper Payments Information Act, see Appendix A.

President's Management Agenda


White House photo by Eric Draper

The Department continues to make progress accomplishing President George W. Bush's Management Agenda. The goal of this Agenda is to improve performance in five key federal management areas. Following is a brief description of each initiative and efforts the Department has undertaken thus far toward successful implementation of the President's Management Agenda.

Strategic Human Capital Management. Even though DoD is engaged in major endeavors overseas, transforming the Department continues to be a priority, as evidenced by the Department's efforts in seeking a National Security Personnel System. Without doubt the flexibility inherent in this system would enable the Department to respond to threats to national interests, while continuing to provide benefits to both DoD military and civilian personnel and link both basic pay and performance incentives directly to the performance measurement process. Further, DoD has developed a Human Resources Strategy which was "cascaded" throughout the Department to ensure that complementary actions are taken across the Department. During FY 2004, the Department also began preparing for the 2005 round of Base Realignment and Closure. Research was conducted to compare current DoD transition tools and outplacement activities to those used in private industry in an effort to minimize adverse effects on our mission and human resources. We instituted formal gap analyses of core mission and critical support occupations. These occupations are analyzed and reported quarterly. No significant gaps have been identified. The Department has also forwarded a Workforce Restructuring Plan to the Office of Management and Budget, describing the organizational plans to meet workforce needs.

Competitive Sourcing. The Department has a goal to compete 226,000 positions by year 2009. DoD far exceeded the Office of Management and Budget's goal of competing 67,800 positions by fiscal year 2004; more than 84,000 positions were competed with an estimated savings of $9.3 billion dollars. In addition, the Department has plans underway for competing more than 9,000 additional positions.

Improving Financial Performance. The Department has three primary initiatives underway to improve its financial performance: the Business Management Modernization Program, Financial Improvement Initiative, and the Financial Management Balanced Scorecard. These initiatives directly respond to financial improvement plans required by the Office of Management and Budget's guidance for the Chief Financial Officer Financial Management 5-Year Plan and Financial Management Systems Plan, as well as the Federal Financial Management Improvement Act's requirement for remediation plans.

Expanding Electronic Government. Of the 25 initiatives identified by the President's Management Council, 18 involve DoD activities. The Department is taking an active role in many of those initiatives. In conjunction with the Office of Management and Budget, the Department will improve management processes relating to the creation and description of business cases for information technology initiatives. The DoD Chief Information Officer is also working closely with Office of Management and Budget on other scorecard elements such as the enterprise architecture, business cases for information technology investments, program management, and security. During the past fiscal year, the Department improved a substantial number of business cases for information technology investments, and made progress on its integrated information technology architectures. The Department also strengthened its information technology security program. The Department is actively engaged with the General Services Administration in the Federal Smart Buy program, which is based on DoD's award-winning Enterprise Software Initiative that has achieved $1.6 billion in cost avoidance since its inception in 1998.

Budget and Performance Integration. The Department uses meaningful performance metrics in managing and justifying program resources. The year 2005 President's budget included performance metrics (to include a Program Assessment Rating Tool for 15 programs) for 40 percent of the Department's resources. Additional efforts are underway to integrate performance metrics into all phases of the Department's planning, programming, budgeting, and execution process.

Summary. The Office of Management and Budget scores the initiatives for each government agency. The scorecard employs a simple grading system: green for success, yellow for mixed results, and red for unsatisfactory. The Department's progress and current status ratings supporting the President's management goals in these five key federal management areas are depicted in the following chart. Further information is available at http://www.results.gov.

The Department cascaded the scoring process to the Services and Defense Agencies this year. The Department has empowered all defense organizations to apply the principles of the President's Management Agenda in a results-oriented manner for their benefit, thus ensuring Department-wide implementation and institutionalization.

The Department is making every effort to implement policies and procedures that accentuate efficiency and sound management principles. The Department is confident this will be reflected positively as it progresses through the coming years.

President's Management Agenda Initiative	Current Status	Progress
Strategic Human Capital Management	Yellow	Green
Competitive Sourcing	Green	Yellow
Improving Financial Performance	Red	Yellow
Expanding Electronic Government	Red	Green
Budget and Performance Integration	Yellow	Green

Message from the Chief Financial Officer

November 15, 2004

The past year has been an important and challenging year for the Department of Defense. We have continued to vigorously fight the global war on terror, while simultaneously transforming the Department to accomplish our mission with ever greater effectiveness.

Our ability to defend our citizens and allies is heavily dependent on being able to obtain and supply the proper resources to our warfighters. Every dollar is important and the way we manage those dollars makes a difference in how successfully we accomplish our mission.

I realize the important responsibility that the Department's financial community has in supplying financial information to those who make decisions about how best to equip and deploy our troops. For this reason, I am committed to transforming the Department's financial community. We have a long way to go, but we are well on the way.

During the past year, the Department made progress on many fronts. We improved the timeliness of our reporting by preparing quarterly financial statements in 21 days and by completing the year-end reporting process in 45 days. During this time, we improved the quality of financial statement data, as evidenced by an increasing number of favorable audit results.

Looking ahead, I see a need for action that is both immediate and long term. Through the Business Management Modernization Program, the Department is overhauling the processes and tools that are used to conduct business. This is an enormous effort that will take time, but will yield tremendous benefits across the entire Department.

Our long term modernization, however, does not stop us from taking immediate action. Each major component within DoD has prepared improvement plans to identify major challenges in financial management and reporting. These plans are key tools for identifying targets of opportunity as we move into a transformed business environment.

I am fully committed to improving the Department's financial management. I will ensure we continue to build on the accomplishments in achieving an unqualified audit opinion on our financial statements and ultimately providing timely, accurate, and reliable financial information to our decision makers.

Tina W. Jonas

Principal Financial Statements and Notes

The principal financial statements included in this report have been prepared in accordance with the requirements of the Chief Financial Officers Act of 1990 (P.L. 101-576), the Government Management Reform Act of 1994 and the Office of Management and Budget's (OMB) Bulletin 01-09, "Form and Content of Agency Financial Statements." The responsibility for the integrity of the financial information included in these statements rests with management of the U.S. Department of Defense. The Department's fiscal years 2004 and 2003 principal financial statements were audited by the Office of Inspector General. The auditors' report accompanies the principal statements.

The Department's principal financial statements for fiscal years 2004 and 2003 consisted of the following:

The **Consolidated Balance Sheet**, which present as of September 30, 2004 and 2003 those resources owned or managed by DoD which are available to provide future economic benefits (assets); amounts owed by DoD that will require payments from those resources or future resources (liabilities) and residual amounts retained by DoD, comprising the difference (net position).

The **Consolidated Statement of Net Cost**, which present the net cost of DoD operations for the years ended September 30, 2004 and 2003. DoD's net cost of operations includes the gross costs incurred by DoD less any exchange revenue earned from DoD activities.

The **Consolidated Statement of Changes in Net Position,** which present the change in DoD's net position resulting from the net cost of DoD operations, budgetary financing sources other than exchange revenues and other financing sources for the years ended September 30, 2004 and 2003.

The **Combined Statement of Budgetary Resources,** which present the budgetary resources available to DoD during FY 2004 and 2003, the status of these resources at September 30, 2004 and 2003, and the outlay of budgetary resources for the years ended September 30, 2004 and 2003.

The **Combined Statement of Financing**, which reconcile the net cost of operations with the obligation of budgetary resources for the years ended September 30, 2004 and 2003.

The **Consolidated Statement of Custodial Activity,** which present the sources and disposition of nonexchange revenues collected or accrued by DoD on behalf of other recipient entities for the years ended September 30, 2004 and 2003.

Limitations of Financial Statements. The following limitations apply to the preparation of the fiscal year 2004 financial statements:

The principal financial statements have been prepared to report the financial position and results of operations of the Department of Defense, pursuant to the requirements of 31 U.S.C. 3515 (b). The statements are prepared from the books and records of the Department in accordance with OMB Bulletin 01-09 and to the extent possible generally accepted accounting principles. The statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

Department of Defense
Agency Wide
CONSOLIDATED BALANCE SHEET
As of September 30, 2004 and 2003
($ in Millions)

		2004 Consolidated		2003 Consolidated Restated
ASSETS (Note 2)				
Intragovernmental:				
Fund Balance with Treasury (Note 3)				
Entity	$	287,685.5	$	251,544.1
Non-Entity Seized Iraqi Cash		113.4		278.1
Non-Entity-Other		1,800.0		239.8
Investments (Note 4)		231,069.7		205,376.0
Accounts Receivable (Note 5)		1,118.3		1,066.6
Other Assets (Note 6)		1,011.9		105.0
Total Intragovernmental Assets	$	522,798.8	$	458,609.6
Cash and Other Monetary Assets (Note 7)	$	2,178.1	$	1,534.9
Accounts Receivable (Note 5)		7,427.8		7,299.9
Loans Receivable (Note 8)		70.7		64.0
Inventory and Related Property (Note 9)		213,219.4		205,544.6
General Property, Plant and Equipment (Note 10)		440,898.6		446,308.9
Investments (Note 4)		406.5		217.8
Other Assets (Note 6)		21,486.3		21,729.6
TOTAL ASSETS	$	1,208,486.2	$	1,141,309.3
LIABILITIES (Note 11)				
Intragovernmental:				
Accounts Payable (Note 12)	$	1,888.4	$	101.4
Debt (Note 13)		591.8		698.2
Environmental Liabilities (Note 14)		0.0		0.0
Other Liabilities (Note 15 & Note 16)		10,726.9		9,739.1
Total Intragovernmental Liabilities	$	13,207.1	$	10,538.7
Accounts Payable (Note 12)	$	28,309.0	$	27,863.8
Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 17)		1,569,704.7		1,429,565.5
Environmental Liabilities (Note 14)		64,367.2		61,490.6
Loan Guarantee Liability (Note 8)		34.4		25.9
Other Liabilities (Note 15 and Note 16)		34,491.2		30,154.0
Debt Held by Public		0.0		0.0
TOTAL LIABILITIES	$	1,710,113.6	$	1,559,638.5
NET POSITION				
Unexpended Appropriations (Note 18)	$	243,813.9	$	218,869.5
Cumulative Results of Operations		(745,441.3)		(637,198.7)
TOTAL NET POSITION	$	(501,627.4)	$	(418,329.2)
TOTAL LIABILITIES AND NET POSITION	$	1,208,486.2	$	1,141,309.3

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Department of Defense
Agency Wide
CONSOLIDATED STATEMENT OF NET COST
For the periods ended September 30, 2004 and 2003
($ in Millions)

	2004 Consolidated	2003 Consolidated
Program Costs		
Intragovernmental Gross Costs	$ 23,574.5	$ 11,748.3
(Less: Intragovernmental Earned Revenue)	(15,429.0)	(13,239.0)
Intragovernmental Net Costs	$ 8,145.5	$ (1,490.7)
Gross Costs With the Public	619,573.8	526,288.4
(Less: Earned Revenue From the Public)	(22,354.4)	(12,507.1)
Net Costs With the Public	$ 597,219.4	$ 513,781.3
Total Net Cost	$ 605,364.9	$ 512,290.6
Cost Not Assigned to Programs	0.0	0.0
(Less: Earned Revenue Not Attributable to Programs)	0.0	0.0
Net Cost of Operations	$ 605,364.9	$ 512,290.6

Department of Defense
Agency Wide
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION
For the periods ended September 30, 2004 and 2003
($ in Millions)

	2004 Consolidated	2003 Consolidated Restated
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	$ (621,610.7)	$ (946,947.7)
Prior period adjustments (+/-)		
Prior Period Adjustments - Restated (+/-)	(15,588.0)	10,534.8
Beginning Balance, Restated	(637,198.7)	(936,412.9)
Prior Period Adjustments - Not Restated (+/-)	699.5	383,074.9
Beginning Balances, as adjusted	(636,499.2)	(553,338.0)
Budgetary Financing Sources:		
Appropriations received	0.0	0.0
Appropriations transferred-in/out (+/-)	0.0	0.0
Other adjustments (rescissions, etc) (+/-)	0.0	(13.0)
Appropriations used	478,621.1	431,548.0
Nonexchange revenue	1,469.7	931.2
Donations and forfeitures of cash and cash equivalents	7.0	24.4
Transfers-in/out without reimbursement (+/-)	10,568.6	1,329.2
Other budgetary financing sources (+/-)	4,511.5	(2,867.4)
Other Financing Sources:		
Donations and forfeitures of property	0.4	4.6
Transfers-in/out without reimbursement (+/-)	(2,848.6)	(6,702.1)
Imputed financing from costs absorbed by others	4,092.5	3,866.9
Other (+/-)	0.6	308.1
Total Financing Sources	496,422.8	428,429.9
Net Cost of Operations (+/-)	605,364.9	512,290.6
Ending Balances	$ (745,441.3)	$ (637,198.7)

Department of Defense
Agency Wide
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION
For the periods ended September 30, 2004 and 2003
($ in Millions)

	2004 Consolidated	2003 Consolidated Restated
UNEXPENDED APPROPRIATIONS		
Beginning Balances	$ 192,955.8	$ 177,282.6
Prior period adjustments (+/-)		
Prior Period Adjustments - Restated (+/-)	25,913.7	0.0
Beginning Balance, Restated	218,869.5	177,282.6
Prior Period Adjustments - Not Restated (+/-)	0.0	0.0
Beginning Balances, as adjusted	218,869.5	177,282.6
Budgetary Financing Sources:		
Appropriations received	512,194.5	477,036.7
Appropriations transferred-in/out (+/-)	485.6	1,217.8
Other adjustments (rescissions, etc) (+/-)	(9,114.6)	(5,137.1)
Appropriations used	(478,621.1)	(431,530.5)
Nonexchange revenue	0.0	0.0
Donations and forfeitures of cash and cash equivalents	0.0	0.0
Transfers-in/out without reimbursement (+/-)	0.0	0.0
Other budgetary financing sources (+/-)	0.0	0.0
Other Financing Sources:		
Donations and forfeitures of property	0.0	0.0
Transfers-in/out without reimbursement (+/-)	0.0	0.0
Imputed financing from costs absorbed by others	0.0	0.0
Other (+/-)	0.0	0.0
Total Financing Sources	24,944.4	41,586.9
Net Cost of Operations (+/-)		
Ending Balances	$ 243,813.9	$ 218,869.5

Department of Defense
Agency Wide
COMBINED STATEMENT OF BUDGETARY RESOURCES
For the periods ended September 30, 2004 and 2003
($ in Millions)

	2004 Combined	2003 Combined
BUDGETARY FINANCING ACCOUNTS		
BUDGETARY RESOURCES		
Budget Authority:		
Appropriations received	$ 582,010.7	$ 546,761.4
Borrowing authority	0.1	0.0
Contract authority	34,855.8	28,109.0
Net transfers (+/-)	(519.3)	1,000.3
Other	0.0	0.0
Unobligated balance:		
Beginning of period	256,659.0	217,722.3
Net transfers, actual (+/-)	782.0	204.3
Anticipated Transfers Balances	0.0	0.0
Spending authority from offsetting collections:		
Earned	0.0	0.0
Collected	146,274.3	135,587.2
Receivable from Federal sources	(79.7)	(714.6)
Change in unfilled customer orders	0.0	0.0
Advance received	360.5	(30.6)
Without advance from Federal sources	980.0	11,000.9
Anticipated for the rest of year, without advances	0.0	0.0
Transfers from trust funds	0.0	0.0
Subtotal	147,535.1	145,842.9
Recoveries of prior year obligations	33,681.9	22,841.9
Temporarily not available pursuant to Public Law	(10.0)	0.0
Permanently not available	(40,338.0)	(33,730.4)
Total Budgetary Resources	$ 1,014,657.3	$ 928,751.7

Department of Defense
Agency Wide
COMBINED STATEMENT OF BUDGETARY RESOURCES
For the periods ended September 30, 2004 and 2003
($ in Millions)

		2004 Combined		2003 Combined
STATUS OF BUDGETARY RESOURCES				
Obligations incurred:				
Direct	$	568,053.7	$	522,562.4
Reimbursable		152,658.9		147,147.8
Subtotal		720,712.6		669,710.2
Unobligated balance:				
Apportioned		58,631.0		55,052.0
Exempt from apportionment		183,488.1		180,704.3
Other available		0.3		(0.1)
Unobligated Balances Not Available		51,825.3		23,285.3
Total, Status of Budgetary Resources	$	1,014,657.3	$	928,751.7
Relationship of Obligations to Outlays:				
Obligated Balance, Net - beginning of period	$	214,371.9	$	181,919.4
Obligated Balance transferred, net (+/-)		(14.1)		(23.9)
Obligated Balance, Net - end of period:				
Accounts receivable		(10,136.8)		(10,216.4)
Unfilled customer order from Federal sources		(39,402.0)		(38,422.1)
Undelivered orders		228,801.3		213,597.8
Accounts payable		53,470.6		49,412.6
Outlays:				
Disbursements		667,755.1		604,105.8
Collections		(146,634.7)		(135,556.8)
Subtotal		521,120.4		468,549.0
Less: Offsetting receipts		(46,546.4)		(43,294.0)
Net Outlays	$	474,574.0	$	425,255.0

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Department of Defense
Agency Wide
COMBINED STATEMENT OF BUDGETARY RESOURCES
For the periods ended September 30, 2004 and 2003
($ in Millions)

	2004 Combined	2003 Combined
NONBUDGETARY FINANCING ACCOUNTS		
BUDGETARY RESOURCES		
Budget Authority:		
Appropriations received	$ 0.0	$ 0.0
Borrowing authority	114.6	50.5
Contract authority	0.0	0.0
Net transfers (+/-)	0.0	0.0
Other	0.0	0.0
Unobligated balance:		
Beginning of period	21.8	104.0
Net transfers, actual (+/-)	0.0	0.0
Anticipated Transfers Balances	0.0	0.0
Spending authority from offsetting collections:		
Earned	0.0	0.0
Collected	17.4	56.2
Receivable from Federal sources	(0.6)	(90.0)
Change in unfilled customer orders	0.0	0.0
Advance received	0.0	0.0
Without advance from Federal sources	47.2	35.8
Anticipated for the rest of year, without advances	0.0	0.0
Transfers from trust funds	0.0	0.0
Subtotal	64.0	2.0
Recoveries of prior year obligations	0.0	1.9
Temporarily not available pursuant to Public Law	0.0	0.0
Permanently not available	20.7	(0.2)
Total Budgetary Resources	$ 221.1	$ 158.2

Department of Defense
Agency Wide
COMBINED STATEMENT OF BUDGETARY RESOURCES
For the periods ended September 30, 2004 and 2003
($ in Millions)

		2004 Combined		2003 Combined
STATUS OF BUDGETARY RESOURCES				
Obligations incurred:				
Direct	$	196.6	$	136.4
Reimbursable		0.0		0.0
Subtotal		196.6		136.4
Unobligated balance:				
Apportioned		1.4		1.3
Exempt from apportionment		0.0		0.0
Other available		0.0		(0.1)
Unobligated Balances Not Available		23.1		20.6
Total, Status of Budgetary Resources	$	221.1	$	158.2
Relationship of Obligations to Outlays:				
Obligated Balance, Net - beginning of period	$	29.9	$	(95.1)
Obligated Balance transferred, net (+/-)		0.0		0.0
Obligated Balance, Net - end of period:				
Accounts receivable		0.0		(0.6)
Unfilled customer order from Federal sources		(83.1)		(35.8)
Undelivered orders		238.8		66.3
Accounts payable		0.0		0.0
Outlays:				
Disbursements		24.1		63.6
Collections		(17.4)		(56.2)
Subtotal		6.7		7.4
Less: Offsetting receipts		0.0		0.0
Net Outlays	$	6.7	$	7.4

Department of Defense
Agency Wide
COMBINED STATEMENT OF FINANCING
For the periods ended September 30, 2004 and 2003
($ in Millions)

	2004 Combined	2003 Combined
Resources Used to Finance Activities:		
Budgetary Resources Obligated		
Obligations incurred	$ 720,909.2	$ 669,846.5
Less: Spending authority from offsetting collections and recoveries (-)	(181,281.0)	(168,688.6)
Obligations net of offsetting collections and recoveries	539,628.2	501,157.9
Less: Offsetting receipts (-)	(46,546.4)	(43,294.0)
Net obligations	493,081.8	457,863.9
Other Resources		
Donations and forfeitures of property	0.4	4.6
Transfers in/out without reimbursement (+/-)	(2,848.6)	(6,702.1)
Imputed financing from costs absorbed by others	4,092.5	3,866.9
Other (+/-)	0.6	308.1
Net other resources used to finance activities	1,244.9	(2,522.5)
Total resources used to finance activities	494,326.7	455,341.4
Resources Used to Finance Items not Part of the Net Cost of Operations		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided		
Undelivered Orders (-)	(13,925.6)	(37,435.1)
Unfilled Customer Orders	1,387.4	11,006.1
Resources that fund expenses recognized in prior periods	(2,637.4)	(686.3)
Budgetary offsetting collections and receipts that do not affect net cost of operations	2,645.4	929.3
Resources that finance the acquisition of assets	(86,943.6)	(72,984.9)
Other resources or adjustments to net obligated resources that do not affect net cost of operations		
Less: Trust or Special Fund Receipts Related to Exchange	(10.0)	0.0
Other (+/-)	2,855.5	6,623.6
Total resources used to finance items not part of the net cost of operations	(96,628.3)	(92,547.3)
Total resources used to finance the net cost of operations	397,698.4	362,794.1

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Department of Defense
Agency Wide
COMBINED STATEMENT OF FINANCING
For the periods ended September 30, 2004 and 2003
($ in Millions)

	2004 Combined	2003 Combined
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Period:		
Increase in annual leave liability	514.8	662.7
Increase in environmental and disposal liability	3,864.6	2,033.6
Upward/Downward reestimates of credit subsidy expense (+/-)	14.9	0.0
Increase in exchange revenue receivable from the public (-)	(73.8)	(6.6)
Other (+/-)	139,064.9	95,403.2
Total components of Net Cost of Operations that will require or generate resources in future periods	143,385.4	98,092.9
Components not Requiring or Generating Resources:		
Depreciation and amortization	42,249.2	55,274.7
Revaluation of assets or liabilities (+/-)	(5,712.6)	6,299.4
Other (+/-)		
Trust Fund Exchange Revenue	(24,285.4)	(23,792.5)
Cost of Goods Sold	41,421.8	0.0
Operating Material & Supplies Used	4,655.9	0.0
Other	5,952.2	13,622.0
Total components of Net Cost of Operations that will not require or generate resources	64,281.1	51,403.6
Total components of net cost of operations that will not require or generate resources in the current period	207,666.5	149,496.5
Net Cost of Operations	605,364.9	512,290.6

Department of Defense
Agency Wide
COMBINED STATEMENT OF CUSTODIAL ACTIVITY
For the periods ended September 30, 2004 and 2003
($ in Millions)

	2004 Combined	2003 Combined
SOURCE OF COLLECTIONS		
Deposits by Foreign Governments	$ 11,237.5	$ 9,971.6
Seized Iraqi Cash	118.3	808.9
Other Collections	0.0	0.0
Total Cash Collections	$ 11,355.8	$ 10,780.5
Accrual Adjustments (+/-)	$ 0.9	$ 0.7
Total Custodial Collections	$ 11,356.7	$ 10,781.2
DISPOSITION OF COLLECTIONS		
Disbursed on Behalf of Foreign Governments and International Organizations	$ 9,998.8	$ 10,118.8
Seized Assets Disbursed on behalf of Iraqi People	283.1	530.8
Increase (Decrease) in Amounts to be Transferred	1,239.5	(146.5)
Collections Used for Refunds and Other Payments	0.0	0.0
Retained by The Reporting Entity	0.0	0.0
Seized Assets Retained for Support of the Iraqi People	(164.7)	278.1
Total Disposition of Collections	$ 11,356.7	$ 10,781.2
NET CUSTODIAL COLLECTION ACTIVITY	$ 0.0	$ 0.0

Note 1. Significant Accounting Policies

1.A. Basis of Presentation

These financial statements have been prepared to report the financial position and results of operations of the Department of Defense (DoD), as required by the "Chief Financial Officers Act of 1990," expanded by the "Government Management Reform Act of 1994," and other appropriate legislation. The financial statements have been prepared from the books and records of the Department in accordance with the "DoD Financial Management Regulation," Office of Management and Budget Bulletin No. 01-09, "Form and Content of Agency Financial Statements," and to the extent possible generally accepted accounting principles (GAAP). The accompanying financial statements account for all resources for which the Department is responsible. Information relative to classified assets, programs, and operations has been excluded from the statements or otherwise aggregated and reported in such a manner that it is no longer classified.

The Department is unable to fully implement all elements of GAAP and Office of Management and Budget Bulletin No. 01-09 due to limitations of its financial management processes and systems, including nonfinancial systems and processes that feed into the financial statements. The Department derives its reported values and information for major asset and liability categories largely from nonfinancial systems, known as feeder systems, such as inventory systems and logistic systems. These systems were designed to support reporting requirements that focus on maintaining accountability over assets and reporting the status of federal appropriations rather than preparing financial statements in accordance with GAAP. The Department continues to implement process and system improvements addressing these limitations.

1.B. Mission of the Reporting Entity

The National Security Act of 1947 established the Department of Defense. The Department's mission is to organize, train, and equip armed forces to deter aggression and, if necessary, defeat aggressors against the United States and its allies. Fiscal Year (FY) 2004 is the ninth year that the Department has prepared audited DOD Agency-wide financial statements as required by the Chief Financial Officers Act and Government Management Reform Act. Auditors are required to audit the financial statements of the following stand-alone reporting entities: (1) Army General Fund, (2) Army Working Capital Fund, (3) Navy General Fund, (4) Navy Working Capital Fund, (5) Air Force General Fund, (6) Air Force Working Capital Fund, (7) Military Retirement Fund, (8) DoD Medicare-Eligible Retiree Health Care Fund, and (9) U.S. Army Corps of Engineers (Civil Works).

In addition to the nine stand-alone reporting entities, separate columns in the combining/consolidating statements are included with the financial information of the "Other Defense Organizations General Funds" and "Other Defense Organizations Working Capital Funds." The Office of the Inspector General will not issue separate audit opinions on the statements of the Other Defense Organizations; instead, the financial statements and records of those organizations will be included in the audit performed to support the opinion issued on the DoD Agency-wide financial statements.

Also, the Department requires the following Defense Agencies to prepare internal stand-alone annual financial statements to be audited by certified public accounting firms: (1) Defense Logistics Agency, (2) Defense Finance and Accounting Service, (3) Defense Information Systems Agency, (4) Defense Contract Audit Agency, (5) Defense Commissary Agency, (6) Defense Security Service, and (7) Defense Threat Reduction Agency.

1.C. Appropriations and Funds

The Department receives its appropriations and funds as general, working capital (revolving funds), trust, special, and deposit funds. The Components use these appropriations and funds to execute their missions and report on resource usage.

General funds are used for financial transactions funded by congressional appropriations, including personnel, operation and maintenance, research and development, procurement, and military construction accounts.

Trust funds contain receipts and expenditures of funds held in trust by the government for use in carrying out specific purposes or programs in accordance with the terms of the donor, trust agreement, or statute.

Special fund accounts are used to process government receipts earmarked for a specific purpose.

Deposit funds are used to record amounts held temporarily until ownership is determined. The Department is acting as an agent or a custodian for funds awaiting distribution, for example payroll taxes.

Working capital funds (WCF) receive their initial funding through an appropriation or a transfer of resources from existing appropriations or funds and use those capital resources to finance the initial cost of products and services. The activities provide goods and services on a reimbursable basis. Receipts derived from operations generally are available in their entirety for use without further congressional action.

1.D. Basis of Accounting

For FY 2004, the Department's financial management systems are unable to meet all of the requirements for full accrual accounting. Many of the Department's financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of GAAP for federal agencies and, therefore, were not designed to collect and record financial information on the full accrual accounting basis as required by GAAP. Most of the Department's legacy systems were designed to record information on a budgetary basis.

The Department has undertaken efforts to determine the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with all elements of GAAP. One such action is the current revision of its accounting systems to record transactions based on the United States Government Standard General Ledger (USSGL). Until all of the Department's financial and nonfinancial feeder systems and processes are updated to collect and report financial information as required by GAAP, the DoD's financial data will be based on budgetary transactions (obligations, disbursements, and collections), transactions from nonfinancial feeder systems, and adjusted for known accruals of major items such as payroll expenses, accounts payable, and environmental liabilities.

In addition, the Department identifies program costs based upon the major appropriation groups provided by the Congress. The Department is in the process of reviewing available data and attempting to develop a cost reporting methodology that balances the need for cost information required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," with the need to keep the financial statements from being overly voluminous.

1.E. Revenues and Other Financing Sources

The Department receives congressional appropriations as financing sources for general funds (annual and a multi-year basis). When authorized, these appropriations are supplemented by revenues generated by sales of goods or services. The Department recognizes revenue as a result of costs incurred or services performed on behalf of other federal agencies and the public. The Department recognizes revenue when earned where systems allow for it. In other instances, revenue is recognized when bills are issued.

The Department does not include non-monetary support provided by U.S. allies for common defense and mutual security in its list of other financing sources that appears in the Statement of Financing. The U.S. has cost-sharing agreements with other countries. Examples include countries where there is a mutual or reciprocal defense agreement, where U.S. troops are stationed, or where the U.S. fleet is in a port.

1.F. Recognition of Expenses

For financial reporting purposes, the DoD policy requires the recognition of operating expenses in the period incurred. However, because the Department's financial and nonfinancial feeder systems were not designed to collect and record financial information on the full accrual accounting basis, accrual adjustments are made for major items such as payroll expenses, accounts payable, environmental liabilities and unbilled revenue. The Department's expenditures for capital and other long-term assets are recognized as operating expenses based on depreciation. In the case of Operating Materials and Supplies (OM&S), operating expenses are generally recognized when items are either purchased or issued to users. Efforts are underway to migrate towards the consumption method for recognizing OM&S expenses. Net increases or decreases in unexpended appropriations are recognized as a change in the net position. Certain expenses, such as annual and military leave earned but not taken, are expensed in the period that payment is made. The Department adjusts operating expenses as a result of the elimination of balances between DoD Components.

1.G. Accounting for Intragovernmental Activities

The Department, as an agency of the federal government, interacts with and is dependent upon the financial activities of the federal government as a whole. Therefore, these financial statements do not reflect the results of all financial decisions applicable to the Department.

Public Debt

The Department's proportionate share of public debt and related expenses of the federal government are not included. The federal government does not apportion debts and its related costs to federal agencies. The DoD's financial statements, therefore, do not report any portion of the public debt or interest thereon, nor do the statements report the source of public financing whether from issuance of debt or tax revenues.

Financing for the construction of DoD facilities is obtained through appropriations. To the extent this financing ultimately may have been obtained through the issuance of public debt, interest costs have not been capitalized since the Department of the Treasury does not allocate such interest costs to the benefiting agencies.

Inter/Intra Governmental Elimination

Preparation of reliable financial statements requires the elimination of transactions occurring among entities within the Department or between two or more federal agencies. However, the Department cannot accurately identify most of its intragovernmental transactions by customer because DoD's systems do not track buyer and seller data needed to match related transactions. For FY 1999 and beyond, seller entities within the Department provided summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side internal DoD accounting offices. In most cases, the buyer-side records have been adjusted to recognize unrecorded costs and accounts payable. Intra-DoD intragovernmental balances were then eliminated. The Department is to develop long-term systems improvements that will include sufficient up-front edits and controls to eliminate the need for after-the-fact reconciliations. The volume of intragovernmental transactions is so large that after-the-fact reconciliation cannot be accomplished effectively with the existing or foreseeable resources.

The Department of the Treasury Financial Management Service (FMS) is responsible for eliminating transactions between the Department and other federal agencies. In May 2004, the FMS issued the Treasury Financial Manual Part 2 – Chapter 4700 "Agency Reporting Requirements for the Financial Report of the United States Government." The Department is not able to fully implement the policies and procedures in this manual related to reconciling intragovernmental assets, liabilities, revenues, and expenses for nonfiduciary transactions. The Department, however, is able to implement the policies and procedures contained in the "Intragovernmental Fiduciary Transactions Accounting Guide," as updated by the "Federal Intragovernmental Transactions Accounting Policies and Procedures Guide," which has been updated and reissued on September 24, 2004. Both documents provide guidance for reconciling Intragovernmental transactions pertaining to investments in federal securities, borrowings from the U.S. Treasury and the Federal Financing Bank, Federal Employees' Compensation Act transactions with the Department of Labor (DoL), and benefit program transactions with the OPM.

1.H. Transactions with Foreign Governments and International Organizations

Each year, the DoD Components sell defense articles and services to foreign governments and international organizations, primarily under the provisions of the "Arms Export Control Act of 1976." Under the provisions of the Act, the Department has authority to sell defense articles and services to foreign countries and international organizations, generally at no profit or loss to the U.S. Government. Customers are required to make payments in advance.

1.I. Funds with the U.S. Treasury

The Department's monetary financial resources are maintained in U.S. Treasury accounts. The Defense Finance and Accounting Service (DFAS), the Military Services, the U.S. Army Corps of Engineers (USACE) disbursing stations, and the Department of State financial service centers process the majority of cash collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports that provide information to the U.S. Treasury on check issues, electronic fund transfers, and interagency transfers and deposits.

In addition, the DFAS sites and the USACE Finance Center submit reports to the Department of the Treasury, by appropriation, on interagency transfers, collections received, and disbursements issued. The Department of the Treasury then records this information to the applicable Fund Balance with Treasury (FBWT) account. Differences between the Department's recorded balance in the FBWT accounts and the Treasury's FBWT accounts sometimes result and are subsequently reconciled.

1.J. Foreign Currency

Cash is the total of cash resources under the control of the Department of Defense, which includes coin, paper currency, negotiable instruments, and amounts held for deposit in banks and other financial institutions. Cash available for agency use includes petty cash funds and cash held in revolving funds, which will not be transferred into the U.S. Government General Fund. Foreign currency consists of the total U.S. dollar equivalent of both purchased and non-purchased foreign currencies held in foreign currency fund accounts. The majority of cash and all foreign currency is classified as non-entity and, therefore, restricted.

The amounts for cash and foreign currency reported consist primarily of cash held by Disbursing Officers to carry out their paying, collecting and foreign currency accommodation exchange missions. Cash seized during Operation Iraqi Freedom is restricted for use to assist the Iraqi people and support the reconstruction of Iraq.

The Department conducts a significant portion of its operations overseas. The Congress established a special account to handle the gains and losses from foreign currency transactions for five general fund appropriations (operation and maintenance, military personnel, military construction, family housing operation and maintenance, and family housing construction). The gains and losses are computed as the variance between the exchange rate at the date of payment and a budget rate established at the beginning of each fiscal year. Foreign currency fluctuations related to other appropriations require adjustments to the original obligation amount at the time of payment. The Department does not separately identify currency fluctuations.

1.K. Accounts Receivable

As presented in the Balance Sheet statement, accounts receivable includes accounts, claims, and refunds receivable from other Federal entities or from the public. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by fund type. The Department does not recognize an allowance for estimated uncollectible amounts from other Federal agencies. Claims against other Federal agencies are to be resolved between the agencies (per Code of Federal Regulations 4CFR 101.)

DoD Components use a variety of techniques for estimating the Allowance for Uncollectible Accounts Receivable from the public. While the exact details differ among the Components, estimates are usually based on either a percentage of actual prior-year write-offs or a percentage of aged receivables from the public.

1.L. Loans Receivable

The Department operates a loan guarantee program authorized by the National Defense Authorization Act for FY 1996 Public Law 104-106, Statute 186, Section 2801. The Act includes a series of authorities that allow the Department to work with the private sector to renovate military housing. The Department's goals are to obtain private capital to leverage government dollars, make efficient use of limited resources, and use a variety of private sector approaches to build and renovate military housing faster and at a lower cost to American taxpayers.

The Act also provides the Department with a variety of authorities to obtain private sector financing and expertise to improve military housing. The Department uses these authorities individually or in combination. They include guarantees, both loan and rental; conveyance/leasing of existing property and facilities; differential lease payments; investments, both limited partnerships and stock/bond ownership; and direct loans. In addition, the "Federal Credit Reform Act of 1990" governs all amended direct loan obligations and loan guarantee commitments made after FY 1991 resulting in direct loans or loan guarantees.

1.M. Inventories and Related Property

Most of the Department's inventories are currently reported at an approximation of historical cost using latest acquisition cost adjusted for holding gains and losses. The latest acquisition cost method is used because legacy inventory systems were designed for materiel management rather than accounting. Although these systems provide visibility and accountability over inventory items, they do not maintain historical cost data necessary to comply with SFFAS No. 3, "Accounting for Inventory and Related Property." Additionally, these systems cannot produce financial transactions using the USSGL, as required by the Federal Financial Management Improvement Act of 1996 (P.L. 104-208). By utilizing new systems development processes, the DoD Components have transitioned, and are continuing to transition, their inventory to the moving average cost method. Upon full implementation, the Department will be compliant with SFFAS No. 3. Approximately 5 percent of inventories are now reported at moving average cost.

The Department manages only military or government-specific materiel under normal conditions. Items commonly used in and available from the commercial sector are not managed in the DoD materiel management activities. Operational cycles are irregular, and the military risks associated with stock-out positions have no commercial parallel. The Department holds materiel based on military need and support for contingencies. Therefore, the Department does not attempt to account separately for "Inventory held for sale" and "Inventory held in reserve for future sale" based on SFFAS No. 3 definitions.

Related property includes OM&S and stockpile materials. OM&S, including munitions not held for sale, are valued at standard purchase price. The Department uses both the consumption method and the purchase method of accounting for OM&S. Items that are centrally managed and stored, and procured by general fund appropriations such as ammunition and engines, are generally accounted by the consumption method and reported on the balance sheet as OM&S. When current systems cannot fully support the consumption method, the Department uses the purchase method - that is, materials and supplies are expensed when purchased. For FY 2004, the Department expensed significant amounts using the purchase method either because the systems could not support the consumption method or because management deemed that the item is in the hands of the end user.

The Department determined that the recurring high dollar value of Operating Materials & Supplies in need of repair is material to the financial statements and requires a separate reporting category. Many high dollar items managed, such as aircraft engines, are categorized as OM&S rather than military equipment by DoD activities.

The Department implemented new policy in FY 2002 to account for condemned materiel only, as "Excess, Obsolete, and Unserviceable." The net value of condemned materiel is zero, because the costs of disposal are greater than the potential scrap value. Potentially redistributable materiel, presented in previous years as "Excess, Obsolete, and Unserviceable," is included in "Held for Use" or "Held for Repair" categories according to its condition.

Past audit results identified uncertainties about the completeness and existence of quantities used to produce the reported values of inventory. Inventory available and purchased for resale includes consumable spare and repair parts and repairable items owned and managed by the Department. This inventory is retained to support military or national contingencies. Inventory held for repair is damaged inventory that requires repair to make suitable for sale. It is more economical to repair than to procure these inventory items. Because the Department often relies on weapon systems and machinery no longer in production, the Department supports a process that encourages the repair and rebuilding of certain items. This repair cycle is essential to maintaining a ready, mobile, and armed military force. Finally, work in process balances include costs related to the production or servicing of items, including direct material, direct labor, applied overhead and other direct costs. Work in process also includes the value of finished products or completed services pending the submission of bills to the customer. The work in process designation may also be used to accumulate the amount paid to a contractor under cost reimbursable contracts, including the amount withheld from payment to ensure performance, and the amount paid to other government plants for accrued costs of end items of materiel ordered but not delivered. Work in process includes munitions in production and depot maintenance work with its associated labor, applied overhead, and supplies used in the delivery of maintenance services.

1.N. Investments in U.S. Treasury Securities

The Department reports investments in U.S. Treasury securities at cost, net of amortized premiums or discounts. Premiums or discounts are amortized into interest income over the term of the investment using the effective interest rate method or another method obtaining similar results. The Department's intent is to hold investments to maturity, unless they are needed to finance claims or otherwise sustain operations. Consequently, a provision is not made for unrealized gains or losses on these securities.

The Department invests in both marketable and non-marketable securities. Marketable securities are investments trading on a public market. The two types of non-marketable securities are par value and market-based intragovernmental securities. The Bureau of Public Debt issues non-marketable par value intragovernmental securities. Non-marketable, market-based intragovernmental securities mimic marketable securities, but are not traded publicly.

The Department's Net Investments are supported by various Trust Funds in each of the reporting entities. These Trust Funds are comprised of Military Retirement Trust Fund (MRF), Medicare-Eligible Retiree Health Care Fund (MERHCF), Other Defense Organizations General Fund (ODO GF), donations (Gift Funds), and the United States Army Corps of Engineers (USACE).

1.O. General Property, Plant and Equipment

SFFAS No. 23 establishes new generally accepted accounting principles for valuing and reporting military equipment (e.g., ships, aircraft, combat vehicles, weapons) in Federal financial statements. The standard requires the capitalization and depreciation of the cost of military equipment, including the cost of modifications and upgrades for accounting periods beginning after September 30, 2002. The Department uses data from the Bureau of Economic Analysis to calculate a value for military equipment.

General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of 2 or more years, and when the acquisition cost equals or exceeds the DoD capitalization threshold of $100,000. Also, DoD requires capitalization of improvement costs over the DoD capitalization threshold of $100,000 for General PP&E. The Department depreciates all General PP&E, other than land, on a straight-line basis.

Prior to FY 1996, General PP&E was capitalized if it had an acquisition cost of $15,000, $25,000, and $50,000 for FYs 1993, 1994, and 1995, respectively, and an estimated useful life of 2 or more years. These assets remain capitalized and reported on WCF financial statements. General PP&E previously capitalized at amounts below $100,000 were written off General Fund financial statements in FY 1998.

The USACE Civil Works General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of 2 or more years, and when the acquisition cost exceeds $25,000. One exception is all buildings and structures related to hydropower projects are capitalized regardless of cost. During 2003, the Corps increased its buildings and structures threshold from $0 to $25K for all Civil Works appropriations with the exception of Revolving Fund and Power Marketing Agency (PMA) assets. All Civil Works buildings and structures currently capitalized under $25,000 (excluding Revolving Fund and PMA) were expensed in FY 2003 and removed from the Corps of Engineers Financial Management System (CEFMS). Beginning in FY 2004 all Civil Works Buildings and Structures under $25,000 are expensed except for PMA assets.

When it is in the best interest of the government, the Department provides government property necessary to contractors to complete contract work. The Department either owns or leases such property, or it is purchased directly by the contractor for the government based on contract terms. When the value of contractor-procured General PP&E exceeds the DoD capitalization threshold, it must be reported on the Department's Balance Sheet.

Regardless, the Department is developing new policies and a contractor reporting process that will provide appropriate General PP&E information for future financial statement reporting purposes. Accordingly, the Department reports only the government property in the possession of contractors that is maintained in the DoD's property systems. Currently the Department does not plan to show contractor-held property as a separate line-item in Note 10.

To bring the DoD into fuller compliance with federal accounting standards, the Department has issued new property accountability and reporting regulations that require the DoD Components to maintain, in their property systems, information on all property furnished to contractors. This action and other DoD proposed actions are structured to capture and report the information necessary for compliance with federal accounting standards.

1.P. Advances and Prepayments

The Department records payments in advance of the receipt of goods and services as advances or prepayments and reports them as assets on the Balance Sheet. In addition, when the Department receives the related goods and services, it recognizes advances and prepayments as expenses.

1.Q. Leases

Generally, lease payments are for the rental of equipment and operating facilities and are classified as either capital or operating leases. When a lease is essentially equivalent to an installment purchase of property (a capital lease), the Department records the applicable asset and liability if the value equals or exceeds the current DoD capitalization threshold. The Department records the amounts as the lesser of the present value of the rental and other lease payments during the lease term (excluding portions representing executory costs paid to the lessor) or the asset's fair market value. The discount rate for the present value calculation is either the lessor's implicit interest rate or the governmental incremental borrowing rate at the inception of the lease. DoD as the lessee receives the use and possession of leased property, for example real estate or equipment, from a lessor in exchange for a payment of funds. An operating lease does not substantially transfer all the benefits and risk of ownership. Payments for operating leases are charged to expense over the lease term as it becomes payable.

Office space is the largest component of operating leases. These costs were gathered from existing leases, General Service Administration (GSA) bills, and Inter-service Support Agreements. Future year projections use the Consumer Price Index (CPI), rather than the DoD inflation factor. The CPI impacts increases to the leases, especially those at commercial lease sites. Equipment leases have a variety of lease terms, which are not expected to be renewed upon expiration. Other operating leases are generally one-year leases. The Department expects to continue to reduce the level of owned assets while increasing the number of leased assets. The Department will strive to displace commercial leases with more economical GSA leases.

Note 5.	Accounts Receivable

As of September 30	2004			2003
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net	Accounts Receivable, Net
(Amounts in millions)				
1. Intra-governmental Receivables:	$ 1,118.3	N/A	$ 1,118.3	$ 1,066.6
2. Non-Federal Receivables (From the Public):	$ 8,028.3	$ (600.5)	$ 7,427.8	$ 7,299.9
3. Total Accounts Receivable:	$ 9,146.6	$ (600.5)	$ 8,546.1	$ 8,366.5

Note 12. Accounts Payable

As of September 30	2004			2003
	Accounts Payable	Interest, Penalties, and Administrative Fees	Total	Total
(Amounts in millions)				
1. Intragovernmental Payables:	$ 1,888.4	N/A	$ 1,888.4	$ 101.4
2. Non-Federal Payables (to the Public):	$ 28,307.2	$ 1.8	$ 28,309.0	$ 27,863.8
3. Total	$ 30,195.6	$ 1.8	$ 30,197.4	$ 27,965.2

Intragovernmental accounts payable consist of amounts owed to other federal agencies for goods or services ordered and received but not paid. Interest, penalties, and administrative fees are not applicable to intragovernmental payables. Nonfederal payables (to the public) are payments to nonfederal entities.

Fluctuations

Intragovernmental Accounts Payable

Intragovernmental accounts payable increased $1.8 billion, (1,762 percent).

Improved business processes and implementation of estimating methodologies allowed DoD agencies to record accounts payable with agencies outside DoD. These new processes resulted in an increase of intragovernmental accounts payable for the following entities:

Army General Fund	$738.7 million
Navy General Fund	$396.6 million
Navy Working Capital Fund	$43.7 million
Air Force General Fund	$542.4 million

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

November 12, 2004

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE
(COMPTROLLER)/CHIEF FINANCIAL OFFICER

SUBJECT: Independent Auditor's Report on the Fiscal Year 2004 DoD Agency-Wide Financial Statements (Report No. D-2005-017)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires Federal agency Inspectors General appointed under the Inspector General Act of 1978, as amended, to audit their respective agency's financial statements or determine that "an independent external auditor" should conduct such audits. Pursuant to this statutory authority, the undersigned Inspector General of the Department of Defense assumed responsibility for auditing the accompanying DoD Agency-Wide Consolidated Balance Sheet as of September 30, 2004 and 2003, the related Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, the Combined Statement of Financing, and the Statement of Custodial Activity for the fiscal years then ended.

The financial statements are the responsibility of DoD management. DoD is also responsible for implementing effective internal control and for complying with laws and regulations. We are unable to give an opinion on the Fiscal Year 2004 financial statements of DoD because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition to our disclaimer of opinion on the financial statements, we are including the required Report on Internal Control and Compliance With Laws and Regulations. The Report on Internal Control and Compliance With Laws and Regulations is an integral part of our disclaimer of opinion on the financial statements and should be considered in assessing the results of the audit.

Disclaimer of Opinion on the Financial Statements

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that (1) the FY 2004 DoD Agency-Wide Financial Statements would not substantially conform to generally accepted accounting principles and (2) DoD financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2004. Therefore, we did not perform auditing procedures to determine whether material amounts on the financial statements were fairly presented. We did not perform these and other auditing procedures because Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Inspector General of the Department of Defense to perform only audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. DoD has also acknowledged, and prior audits have identified, the material weaknesses listed in the Summary of Internal Control. These material weaknesses also

"A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." - Constitution of the United States, Article I, Section 9

affect the reliability of certain information contained in the annual financial statements—much of which is taken from the same data sources as the principal financial statements.[1] As described above, we are unable to express, and we do not express, an opinion on the financial statements and the accompanying information.

Summary of Internal Control

In planning our audit, we considered DoD internal control over financial reporting and compliance. We did this to determine our procedures for auditing the financial statements and to comply with Office of Management and Budget guidance but our purpose was not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance. However, previously identified reportable conditions,[2] all of which are material, continued to exist in the following areas:

- Financial Management Systems;
- Fund Balance with Treasury;
- Inventory;
- Operating Materials and Supplies;
- General Property, Plant, and Equipment (PP&E);
- Government-Furnished Material and Contractor-Acquired Material;
- Environmental Liabilities;
- Intragovernmental Eliminations;
- Other Accounting Entries;
- Statement of Net Cost; and
- Statement of Financing.

A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance that are material in relation to the financial statements would be prevented or detected on a timely basis. Our internal control work would not necessarily disclose all material weaknesses. See the Attachment for additional details on material internal control weaknesses.

[1] The annual financial statements include the principal financial statements, management discussion and analysis, consolidating and combining financial statements, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information.

[2] Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to management because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in financial statements.

"A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." - Constitution of the United States, Article I, Section 9

Summary of Compliance With Laws and Regulations

Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited because management acknowledged, and prior audits confirm, that instances of noncompliance continue to exist. The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that DoD financial management systems do not comply substantially with Federal financial management system requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level. Therefore, we did not determine whether DoD was in compliance with all applicable laws and regulations related to financial reporting. See the Attachment for additional details on compliance with laws and regulations.

Management Responsibility

Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met; and
- complying with applicable laws and regulations.

We provided a draft of this report to personnel in the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer who provided technical comments, which have been incorporated as appropriate. These officials expressed their continuing commitment to address the problems this report outlines.

Joseph E. Schmitz
Inspector General
Department of Defense

Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing Service

Attachment:
As stated

"A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." - Constitution of the United States, Article I, Section 9

Report on Internal Control and Compliance With Laws and Regulations

Internal Control

Management is responsible for implementing effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly and that assets are safeguarded against misappropriation and abuse. Our purpose was not to, and we do not, express an opinion on internal control over financial reporting. However, management acknowledged that previously identified reportable conditions, all of which are material, continue to exist. The following financial management deficiencies are indications of material weaknesses in internal control that may adversely affect any decision by DoD that is based, in whole or in part, on information that is inaccurate because of these deficiencies. Financial information reported by DoD also may contain misstatements resulting from these deficiencies.

Financial Management Systems. Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, "Objectives of Federal Financial Reporting," requires financial management systems controls that are adequate to ensure that transactions are executed in accordance with budgetary and financial laws and other requirements, are consistent with the purposes authorized, and are recorded in accordance with Federal accounting standards. SFFAC No. 1 also requires that financial management systems controls ensure that assets are properly safeguarded to deter fraud, waste, and abuse; and that performance measurement information is adequately supported. The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged that many DoD financial management systems do not substantially comply with Federal financial management systems requirements. DoD financial management and feeder systems were not designed to adequately support various material amounts on the financial statements. These systemic deficiencies in financial management and feeder systems and inadequate DoD business processes result in the inability to collect and report financial and performance information that is accurate, reliable, and timely.

Fund Balance with Treasury. DoD is required by the Treasury Financial Manual and DoD Financial Management Regulation 7000.14-R, to resolve financial and accounting inconsistencies to accurately report Fund Balance with Treasury. However, inconsistencies continue to exist related to in-transit disbursements, unmatched disbursements, negative unliquidated obligations, unreconciled differences in suspense accounts, and unreconciled differences between U.S. Treasury records and DoD accounting records.

Inventory. DoD is required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 3, "Accounting for Inventory and Related Property," to use historical cost or the latest acquisition cost adjusted for holding gains and losses or moving average cost for valuing Inventory. However, DoD acknowledged that the existing inventory valuation at most activities does not

Attachment

approximate historical cost. Additionally, DoD does not distinguish between Inventory Held for Sale and Inventory Held in Reserve for Future Sale, as required by SFFAS No. 3.

Operating Materials and Supplies. SFFAS No. 3 also states that Operating Materials and Supplies must be expensed when the items are consumed. DoD has acknowledged that significant amounts of Operating Materials and Supplies were expensed when purchased instead of when they were consumed. In addition, DoD acknowledged that significant amounts of Operating Materials and Supplies in the possession of contractors were not included in the Operating Materials and Supplies account balance.

General Property, Plant, and Equipment. DoD is required by SFFAS No. 6, "Accounting for Property, Plant, and Equipment," to record PP&E at acquisition cost, capitalize improvement costs, and recognize depreciation expense. However, DoD has acknowledged that it is unable to accurately report the value of PP&E on its financial statements. DoD legacy property and logistic systems were not designed to capture acquisition cost, costs of modifications and upgrades, or calculate depreciation. In addition, value of DoD PP&E is not reliably reported because of a lack of supporting documentation.

Government-Furnished Material and Contractor-Acquired Material. SFFAS No. 11, "Amendments to Accounting for Property, Plant, and Equipment," requires that property and equipment in the possession of a contractor for use in accomplishing a contract be considered Government property. Government property should be accounted for based on the nature of the item, regardless of who has possession. DoD has acknowledged, and prior audits confirm, that it is unable to comply with applicable requirements for Government-Furnished Materials and Contractor Acquired-Materials. As a result, the value of DoD property and material in the possession of contractors is not reliably reported.

Environmental Liabilities. DoD acknowledged that guidance and audit trails for estimating environmental liabilities are incomplete. Environmental liability estimates were unreliable because activities did not have effective controls in place to ensure that adequate audit trails and supporting documentation for estimates exist, and that they comply with established guidance in developing estimates and maintain reliable feeder and coordination systems. In addition, material uncertainties exist related to environmental cleanup because of incomplete documentation for cleanup costs.

Intragovernmental Eliminations. DoD acknowledged that it made unverifiable adjustments because of the inability to reconcile most intragovernmental transactions. For example, the Defense Finance and Accounting Service-Indianapolis entered more than $59 billion in unsupported adjustments to Army intragovernmental accounts to bring them into agreement with related amounts reported by its trading partners.

Other Accounting Entries. DoD acknowledged that it continues to enter material amounts of unsupported accounting entries. For example, the Defense Finance and Accounting Service-Indianapolis recorded $204.8 billion (excluding adjustments for intragovernmental transactions) in unsupported accounting entries to prepare the FY 2004 Army General Fund Financial Statements.

Attachment

Statement of Net Cost. SFFAC No. 2, "Entity and Display," requires the Statement of Net Cost to provide an understanding of the net costs of each organization and each program. In addition, the Statement of Net Cost should provide gross and net cost information that can be related to the amounts of outputs and outcomes for the programs and/or organization. DoD acknowledged the following deficiencies related to the Statement of Net Cost.

- The amounts presented for General Funds may not report actual accrued costs.
- Although the funds are generally recorded on an accrual basis for Working Capital Funds, as is required by generally accepted accounting principles, the systems do not always capture actual costs in a timely manner.
- Current financial processes and systems do not capture and report accumulated costs for major programs based on performance measures as required by the Government Performance and Results Act.
- DoD accounting systems do not capture cost data in a manner that enables DoD to determine if the costs were incurred to generate intragovernmental revenue.
- DoD accounting systems do not capture trading partner data at the transaction level in a manner that facilitates trading partner aggregations. Consequently, DoD was unable to reconcile intra-governmental revenue balances with its trading partners.

Statement of Financing. SFFAS No. 7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting," states that the Statement of Financing should reconcile resources obligated during the period to the net cost of operations. However, DoD acknowledged that it is unable to reconcile budgetary obligations to net costs without making adjustments. Specifically, budgetary data are not in agreement with proprietary expenses. DoD disclosed in Note 22 that the Statements of Financing and Net Cost were adjusted by $10,071.7 million (absolute value) to bring them into agreement. Lastly, DoD presented the Statement of Financing on a combined basis instead of a consolidated basis as required by Office of Management and Budget (OMB) Bulletin No. 01-09, "Form and Content of Agency Financial Statements."

Compliance With Laws and Regulations

Management is responsible for compliance with existing laws and regulations related to financial reporting. Our work to determine compliance with selected provisions of the applicable laws and regulations was limited because management acknowledged instances of noncompliance, and previously reported instances of noncompliance continued to exist. Therefore, we did not determine whether DoD was in compliance with selected provisions of all applicable laws and regulations related to financial reporting. Our objective was not to, and we do not, express an opinion on compliance with applicable laws and regulations.

Attachment

Statutory Financial Management Systems Reporting Requirements. DoD is required to comply with the following financial management systems reporting requirements.

- Section 3512, title 31, United States Code, incorporates the reporting requirements of the FMFIA of 1982 and requires DoD to evaluate its systems and to annually report whether those systems are in compliance with requirements prescribed by the Comptroller General.
- The Federal Financial Management Improvement Act (FFMIA) of 1996 requires DoD to establish and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. The FFMIA also requires DoD to develop a remediation plan when its financial management systems do not comply with Federal financial management systems requirements. The remediation plan is to include remedies, resources required, and milestones.

For FY 2004, DoD did not fully comply with the statutory reporting requirements identified in these provisions. Specifically, DoD acknowledged that many of its critical financial management and feeder systems did not comply substantially with Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2004. In an attempt to remedy these long-standing financial management systems deficiencies, DoD is developing a DoD-Wide Business Enterprise Architecture. However, the Business Enterprise Architecture falls short of meeting the requirements of a remediation plan under the FFMIA because the architecture does not identify the resources required to correct the noncompliance with Federal financial management system requirements. Until the architecture is fully developed and implemented, DoD will continue to be unable to fully comply with the statutory reporting requirements. We did not perform tests of compliance for these requirements.

Antideficiency Act. Title 31, section 1341 of the United States Code states that an officer or employee of the United States Government may not "make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund for the expenditure or obligation;" or "involve either government in a contract or obligation for the payment of money before an appropriation is made unless otherwise authorized by law." During FY 2004 DoD completed 33 investigations of potential violations of the Antideficiency Act, and determined that 21 were actual violations.

In response to violations of the Antideficiency Act, title 31, sections 1351 and 1349 require DoD to immediately report the nature of violations to the President and Congress and to take appropriate disciplinary action against those responsible for the violations. In a recent audit of Antideficiency Act cases closed in FYs 2002 and 2003,[3] we identified that DoD was not reporting Antideficiency Act violations to the President and Congress in a timely manner. Additionally, the audit identified that DoD Components did not consistently take appropriate

[3] OIG DoD Audit Report No. D-2005-0003, "DoD Antideficiency Act Reporting and Disciplinary Process," October 14, 2004

Attachment

disciplinary action against personnel responsible for violations of the Antideficiency Act. Our review of Antideficiency Act investigations closed in FY 2004 showed that delays continue; however, DoD is taking aggressive action to significantly reduce the time to investigate and report violations.

Prompt Payment Act. The Prompt Payment Act requires DoD to maintain an internal control environment in accordance with OMB Circular A-123 "Management Accountability and Control." In prior audit reports, we identified outstanding deficiencies in the DoD internal control environment as it relates to payments. Specifically, deficiencies related to access and accountability for resources, recording, and documentation have not been corrected.

Audit Disclosures

We did not perform audit work related to the following selected provisions of laws and regulations: Government Performance and Results Act, Debt Collection Improvement Act, Federal Credit Reform Act, and the Pay and Allowance System for Civilian Employees.

This report does not include recommendations to correct the material internal control weaknesses and instances of noncompliance because previous audit reports contained recommendations for corrective actions.

Attachment

Additional copy of Note 5 for students to tear out of Student Guides to follow in class.

Note 5.	Accounts Receivable

As of September 30	2004			2003
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net	Accounts Receivable, Net
(Amounts in millions)				
1. Intra-governmental Receivables:	$ 1,118.3	N/A	$ 1,118.3	$ 1,066.6
2. Non-Federal Receivables (From the Public):	$ 8,028.3	$ (600.5)	$ 7,427.8	$ 7,299.9
3. Total Accounts Receivable:	$ 9,146.6	$ (600.5)	$ 8,546.1	$ 8,366.5

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Note 12.	**Accounts Payable**

As of September 30	2004			2003
	Accounts Payable	Interest, Penalties, and Administrative Fees	Total	Total
(Amounts in millions)				
1. Intragovernmental Payables:	$ 1,888.4	N/A	$ 1,888.4	$ 101.4
2. Non-Federal Payables (to the Public):	$ 28,307.2	$ 1.8	$ 28,309.0	$ 27,863.8
3. Total	$ 30,195.6	$ 1.8	$ 30,197.4	$ 27,965.2

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Army General Fund	$738.7 million
Navy General Fund	$396.6 million
Navy Working Capital Fund	$43.7 million
Air Force General Fund	$542.4 million

Office of the Under Secretary of Defense (Comptroller) (OUSD(C))

Preparing for Audits of Accounts Receivable and Accounts Payable

Final Examination

Student Name: ____________________________

Version 1.0 **October 2005**

Prepared by:
Science Applications International Corporation
Southbridge Hotel and Conference Center
14 Mechanic Street, Room C-3100
Southbridge, MA 01550-2570

An Employee-Owned Company

Final Examination

Directions This final examination assesses the students' knowledge of preparing for audits of Accounts Receivable and Accounts Payable. The questions are multiple choice and fill in the blank. Write in or circle the correct answers to each question.

Time Allocation The time allocated to this examination is 40 minutes: 30 minutes for the exercise and 10 minutes for the critique.

Number	Question
1	What is an Accounts Receivable? a. Money or other assets you owe to another entity b. A claim to cash or other assets against another entity c. An amount reported to the IRS as income to the debtor d. Amounts due within the next 12 months
2	When are payables recognized? a. Upon actual or constructive delivery of a good or service b. Upon receipt of an invoice c. When payment is due d. 30 days after actual or constructive receipt of a good or service
3	Which of the following represents an intra-governmental transaction? a. A DoD liability owed to the State of Alabama b. A DoD receivable due from a non-appropriated fund activity c. A DoD liability owed to a foreign government d. A DoD liability owed to the General Services Administration (GSA)

Number	Question
4	What information is contained in Note 5 to the financial statements? a. Significant Accounting Policies b. Accounts Receivable c. Accounts Payable d. Debt
5	From what date is a receivable that is recorded as delinquent, aged? a. The date specified in an agreement or instrument b. The payment due date c. The date notification of debt was mailed d. Any of the above
6	What controls should be in place to ensure that customers are billed for all shipments with no duplicate billing and at authorized prices? a. An independent check by billing department personnel of the existence of a shipping document and matching approved sales order b. Use of an authorized price list or computerized master price file and manual independent checks or computer program checks on the pricing and mathematical accuracy of sales invoices c. Comparison of control totals for shipping documents with corresponding totals for sales invoices d. All of the above
7	In the cross-servicing process who retains responsibility for reporting the debts? a. The Treasury b. The DoD c. The referring agency d. The debt collection service

Number	Question
8	According to SFFAS No. 1, when should losses on receivables be recognized? a. When they are 180 days old b. When it is more likely than not that the receivable will not be totally collected c. When they have been referred to the Treasury d. When they are two years old
9	What guidance describes the requirement for timely payment of debt to the public from federal entities? a. Chief Financial Officers Act b. Federal Managers Financial Integrity Act c. Prompt Payment Act d. OMB Circular No. A-123, Management's Responsibility for Internal Control and Appendix A
10	Which of the following are compatible duties? a. Approval and receipt of a purchase b. Approval of a payment voucher and reconciliation of the financial records c. All of the above d. None of the above
11	What is/are the only valid cause(s) for disputed billing of an intra-governmental payable? a. Lack of supporting documentation or authority to bill b. Duplicate billing c. Non-receipt of goods or services d. All of the above

Number	Question
12	How often are reviews of outstanding commitments and unliquidated obligations required (to include Accounts Receivable and Accounts Payable)? a. Annually b. Tri-annually c. Quarterly d. Monthly
13	What is the purpose of the Validation Phase? a. To validate the analysis of the auditors b. To validate the effectiveness of the corrective actions c. To notify the DoD OIG that validation of corrected deficiencies has been completed and that a financial statement or line item is ready for audit d. To determine the reliability of the line or statement which the entity asserted as being ready for audit
14	During what phase does the entity notify the DoD OIG that the line items are ready for audit? a. Validation Phase b. Assertion Phase c. Assessment Phase d. Audit Phase
15	List three possible sources of information for the identification of problems in your operations. ____________________ ____________________ ____________________